

# Response to ESMA Consultation Paper to Implementing Measures for the AIFMD

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## Abstract

Several regulatory initiatives are being taken in Europe and recommendations that will reshape the investment fund industry are being made. Existing regulations, such as UCITS, are being reshaped; the need for a regulation of depositaries has been acknowledged, and since the G20 there has been more focus on the monitoring of hedge funds.

Many of these regulatory needs have converged in the alternative investment fund managers' directive (AIFMD), which means that the AIFMD could become a unique framework that settles most of the questions related to the common framework for funds, fund managers and depositaries. However, it must avoid the risk of the AIFMD not being applicable if it appears as a patchwork of diverging goals that have been grouped into a single directive solely for political reasons.

In previous research carried out as part of the CACEIS research chair at EDHEC-Risk Institute on "Risk and Regulation in the European Fund Management Industry" we have carried out an extensive survey of industry views on structuring hedge fund strategies as UCITS ("Are Hedge-Fund UCITS the Cure-All?" March 2010) and produced a comprehensive report on non-financial risk and performance in a changing regulatory framework in Europe ("The European Fund Management Industry Needs a Better Grasp of Non-financial Risks" December 2010).

The present position paper addresses the measures for implementation of the AIFMD. The AIFMD must afford a convergence of views between civil-law and common-law regulations and cultures. It has specified many of the depositary duties and obligations, with sufficient details for an implementation in civil-law countries, while retaining sufficient margin for manoeuvre for an application in common-law countries.

As the AIFMD only facilitates the marketing of funds but not their distribution, a confused, inadequate or costly directive could end-up pushing hedge fund managers to either remain in the unregulated space or switch to the flexible UCITS framework, which allows the packaging of hedge fund strategies as NewCITS.

Another criticism of the current directive is that too little attention has been paid to the necessary transparency for investors. Lastly, the AIFMD and ESMA proposals fail to ensure uniform application of many legal principles (such as the fiduciary duties of the investment firm) in the various countries. A specific section should be dedicated to ESMA's powers of law enforcement and guidelines for a homogenous, practical regulation of fiduciary duties.

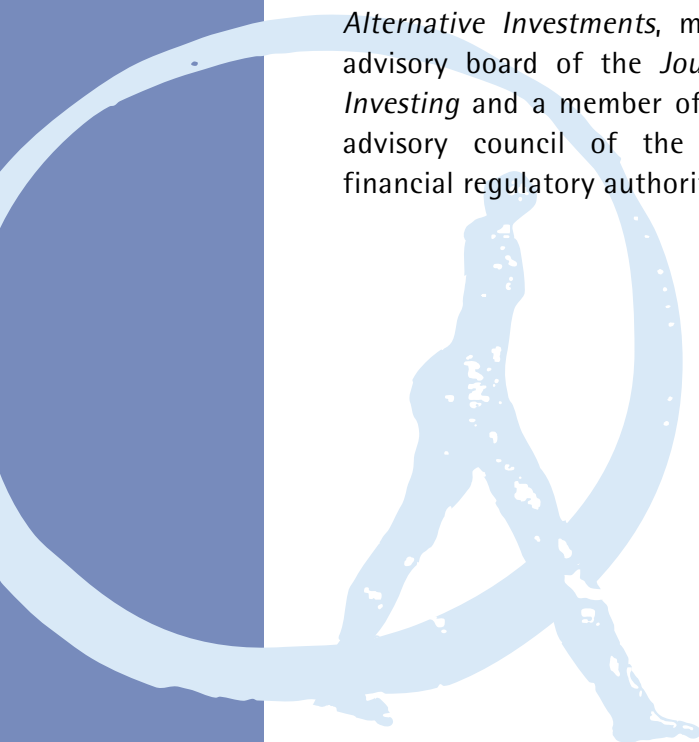
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The work presented herein is a detailed summary of academic research conducted by EDHEC-Risk Institute. The opinions expressed are those of the authors. EDHEC-Risk Institute declines all responsibility for any errors or omissions.

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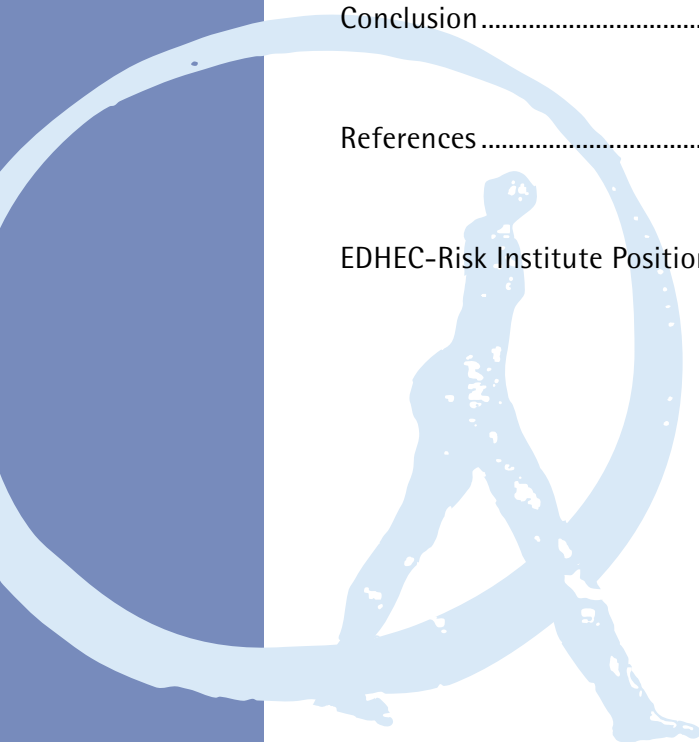
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## Table of Contents

1. The History of the Alternative Investment Fund Manager's Directive (AIFMD) .....	5
2. The Lack of Clear Objectives for the AIFMD .....	7
3. Which Regulatory Approach is Appropriate for Hedge-Funds? .....	10
4. The Directive and ESMA Implementation Advice .....	11
Conclusion .....	16
References .....	17
EDHEC-Risk Institute Position Papers and Publications (2008-2011) .....	18



# 1. The History of the Alternative Investment Fund Manager's Directive (AIFMD)

The creation of a European regulation for hedge funds was decided upon after the Commission Green Paper on investment funds was published (EC, 2005) and it began with the creation of an Expert Group on Alternative Investment Funds in January 2006.

In the early years of this process, many politicians had a prior anti hedge-fund stance, an example being Müntefering from the German SPD who compared private equity groups and short-term investors such as hedge funds to "swarms of locusts" that fall on companies, devour all they can and then move on. Many politicians assumed that hedge funds could not be a legitimate part of the financial system and it was commonly assumed that hedge funds would be the trigger of the next financial crisis. Under these influences, some initial proposed acts had an anti-hedge fund flavour which triggered swift opposition from the industry.

However, the crisis did originate at the heart of prestigious and highly-regulated financial institutions, banks. With regard to hedge funds, the *de Larosière High Level Group* has summarised the situation as follows: 'Concerning hedge funds, the Group considers they did not play a major role in the emergence of the crisis. Their role has largely been limited to a transmission function, notably through massive selling of shares and short-selling transactions.'

The crisis not only led to politicians updating their preconceptions on hedge funds to more favourable terms, but it also led to a great change in scope and new priorities for the AIFMD. In 2009, the G20 decided to monitor sources of systemic risk. The EU made specific legislative and organisational proposals in this respect, with the creation of two supervisory systems – the European Systemic Risk Board, in charge of macro-supervision, and the European

System of Financial Supervisors (ESFS) for the supervision of individual financial institutions. At the same time, regulatory bodies proposed an extension of the role of central counterparties to derivatives (i.e. clearing houses that do not just match transactions but also assume counterparty risk associated with derivative instruments) and repositories that simply centralise information have also been created. This aspect has also gained relevance in the AIFMD, which we will comment on separately.

As Madoff was a US-based hedge fund advisor who did not even need to register with the US regulator, nor be subject to very basic governance requirements, the importance of having minimum requirements to hedge funds to at least prevent the most basic frauds such as Ponzi schemes was reassessed on both sides of the Atlantic and reaffirmed by the G20. In the US, the Dodd-Frank act requires the registration of hedge funds; in Europe, despite the recognition that most hedge fund managers are regulated (the majority by the UK FSA) and subject to information requirements, the AIFMD still contains extended means of control.

In addition, the crisis led to the understanding that depositary rules in Europe where country-specific rather than homogenous (See Amenc and Sender, 2010b). The Madoff affair illustrated that the responsibilities and actual liabilities of depositary liabilities were very diverse, even inside the UCITS space, and that the UCITS framework itself needed serious updating for it to remain a 'gold standard' inside and outside the EU. For ambiguous reasons, it was decided that the first common set of depositary rules and regulations would be included in the AIFMD, which could lead to the belief that in Europe, external monitoring requirements are implicitly

## 1. The History of the Alternative Investment Fund Manager's Directive (AIFMD)

synonymous with the control duties of depositaries – even when this would not bring additional security or when this could mean duplicated tasks. It would have been far more logical to first have a separate depositary directive (as a logical continuation of the EU consultation on the UCITS depositary function that took place in 2009) then to devise appropriate monitoring devices for hedge funds.

On the whole, politicians suddenly awakened by the crisis and aware of systemic risk, credit derivatives, but also the divergences of national regulations for the depositary function even in UCITS funds, decided to significantly expand the original scope of the AIFMD, notably by including the first proposed pan-European regulation for depositaries. The extended scope of the AIFMD and the that it is designed to tackle many of the regulatory issues regarding all European investment funds makes it the most important directive in the contemporary landscape.

## 2. The Lack of Clear Objectives for the AIFMD

Hedge fund always have the option not to submit to the AIFMD and remain unregulated. This possibility should dictate a need for pragmatic, workable and understandable regulations.<sup>1</sup>

Such objectives have been missing due to the AIFMD being largely driven by political intentions. In addition, this has arguably led (during the course of its drafting) to both numerous errors and to delays in the drafting and approval of the directive. It is thus worth contrasting the AIFMD situation with the sole implemented European framework for investment funds – the UCITS framework.

UCITS by contrast has, from the outset benefited from a clear objective, which with subsequent developments can be defined as allowing collective investment schemes to operate freely throughout the EU on the basis of a single authorisation from one member state. As UCITS was drafted at a time when funds principally invested in domestic listed securities and when depositaries could ensure safekeeping, it rapidly became synonymous with the security, transparency and liquidity it could then objectively afford investors: despite the ambiguity of its articles and provisions (as was recently found out), UCITS became a brand.

We argue that the AIFMD must have a similar, clear objective. A reasonable

objective would be to provide a generic framework for all regulated investment funds. Then, the AIFMD would clearly define the rules that apply to all actors in the value chain, and separate product regulations would need to be defined for each relevant category of product. These product regulations would define eligible assets and strategies, the liquidity of units, information displayed and, ideally, they would also define distribution rules in an integrated, simple and understandable approach. UCITS could then explicitly be one of a series of product regulations rather than one of the directives that, together with AIFMD, shape the framework for European investment funds in a rather complex fashion due to the multiple (and sometimes random or unexpected) interactions between independently-conceived directives. After all, the understanding that UCITS, despite its strong brand name, can no longer be perceived as a generic and unique framework means that more comprehensive rules are needed. If politicians have decided to have these rules written in the AIFMD, then the directive must be workable and adopted. It must provide a rationale and a feasible, rather than a punitive, framework;<sup>2</sup> other objectives must be considered as secondary.

Moreover, the other objectives cannot be achieved before this one. If the main objective was to monitor systemic risk or even manage it by controlling the leverage

### Do we need a New Unique Framework for Investment Funds?

The UCITS directive has been labelled the "EU framework for investment funds" (see the EU Green and White papers). The recent crisis has proved that UCITS is no longer a basic, simple and homogenous investment fund framework that would suffice the EU community.

Firstly, experience has shown that the UCITS framework is not unique, but in fact fragmented. Sophisticated UCITS or NewCITS contribute to a de facto fragmentation, and UCITS funds are not solely basic retail funds as once was the case.<sup>3</sup> The crisis has

1 - For instance, regulating hedge funds with the preconception that they are guilty and the notion that punitive regulation is needed cannot be efficient.

2 - As the surge of NewCITS illustrates, there is a strong demand for regulated funds. So, we do not even require the AIFMD to be attractive, only that it is not improperly-drafted.

3 - The regulatory acknowledgement of the actual development in fund management techniques are represented by (i) the definition of sophisticated UCITS in the UCITS directive, (ii) recommendation EC/2004/383 and (iii) the CESR advice on eligible assets.

## 2. The Lack of Clear Objectives for the AIFMD

also led to the understanding that depositary rules and supervision practices vary across countries and, as a consequence, so does the degree of protection in UCITS funds.<sup>4</sup>

So, having become well-understood by the European Commission, the hedge fund industry has consistently and steadily gathered importance, growing steadily since the 1990s, and despite the recent wave of hedge-fund UCITS, Amenc and Sender (2010) show that UCITS is neither sufficient to encapsulate all strategies, nor to respond to the institutional demand because of the true need for illiquid assets and alternative strategies.

So, there may be not only the need for an update and clarification of the UCITS framework, but also of a more comprehensive framework for European regulated funds. Of course, since UCITS must be adapted to retail investors, while the AIFMD primarily serves professional investors, one can question whether the AIFMD can serve as a global framework that would include UCITS. By including the depositary regulation in the AIFMD, and by explicitly relying on some of the UCITS objectives and references, regulators and politicians have implicitly answered the question, confirming that the AIFMD is a general framework that could encapsulate UCITS. However, they have not been explicit about this goal.

We also believe that the AIFMD provides the opportunity to draft a principle-based European regulation - it has been missing for alternatives, as it has in the UCITS framework - a lack which has been highlighted by the crisis, Lehman and Madoff altogether (see Amenc and Sender, 2010b).

We thus suggest that one of the primary objectives of the AIFMD should be to define and create such a European regulatory framework - with a brand name as clear as UCITS funds once had and probably still have in the eye of the global investment community. The success of UCITS comes from its brand and the ease with which it distributes; these form the major appeal of the product from the point of view of producers. So, a successful brand for a large class of strategies needs to be based on regulation that is reliable and transparent, yet cheap. It must facilitate distribution; the ease with which one can distribute a strategy is a major incentive to submit to a regulation.

of AIFM funds, the bulk of managers would certainly be needed to adopt and submit to the directive. If the AIFMD is not attractive, then it will be easier to monitor systemic risk throughout transaction repositories (data warehouses where all transactions on some asset classes are recorded).

When it comes to protection, one must also beware that for professional investors the need for regulatory protection only is

attractive if it comes at an efficient price - a price lower than what it costs for them to achieve the same protection privately. It sometimes seems that the AIFMD has erroneously inherited from objectives that are perfectly suited to retail investors, but could be unsuitable for the professional investors who buy alternative funds. For these investors, the basic requirements of good governance, which is characterised by independence of control; of strong and

4 - The Chilean pension regulation requires monitoring of the domicile country of funds' credit rating, and in early 2011, Chile placed Ireland's fund industry on watch.

## 2. The Lack of Clear Objectives for the AIFMD

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meaningful fiduciary duties of all parties towards investors; of segregation of funds, and of transparency towards investors, could come at a far better price than extreme and inappropriate administrative protection such as inapplicable or costly obligations of restitutions.



### 3. Which Regulatory Approach is Appropriate for Hedge Funds?

The civil-law approach to financial regulations<sup>5</sup> is arguably an available option for retail investment funds.<sup>6</sup> But in our opinion such an approach could arguably not apply to hedge funds, who set the boundaries of their own investment rules. The necessary variety in hedge funds means that hedge fund regulations, to which the AIFMD belongs, can be nothing but a principle-based regulation inspired from the common-law approach.

From a practical standpoint, the only existing model of hedge fund regulation is the UK model, sometimes referred to as the London model.<sup>7</sup> The UK is the hedge-fund centre of the EU, and for off-shore locations that encourage the establishment of hedge funds on their soil, UK best practices and high-level principles are often adopted.<sup>8</sup> The principles could be described as ensuring segregation, independent auditing, division of responsibility and transparency, both towards the investors and the regulators.

Due to the diversity of hedge funds, having overly-detailed rules always causes the risk of having unnecessary costs when rules are inappropriate. We are aware, however, that the diverging cultures mean that in practice, some degree of detail is necessary for an implementation within civil-law countries, and we believe that the directive has, for instance, described with sufficient detail the situations where depositaries could be exonerated from the liability of restitution (in fact, the ESMA [2011] consultation alone is close to 500 pages and the directive close to 250). However, convergence is a two-way process, and the notion that fiduciary

duties are taken seriously in civil-law countries is part of the solution:<sup>9</sup> for a principle-based regulation to be effective in civil-law countries, it must be enforced with a degree of severity, and this may be insufficiently detailed in the directive (with the exception of depositaries whose liabilities have been clearly spelt out). When an asset manager or a depositary voluntarily breaches its obligations and enters into strong conflicts of interest, it must be penalised, as it can be by the FSA – in 2006, both the managing director of GLG Partners and the firm itself were fined of £750,000 for market abuse and violation of FSA principles.

5 - It is worth recalling that there are three main influences to the financial regulations (Amenc and Sender, 2010b). The first and better known is the difference between common and civil law regulations (see La Porta et al., 1998); the second and third are the difference between financial regulations and corporate regulations, and whether the country considered is home of savings or promotes the export of funds or services. The civil-law approach entails very detailed rules and prescriptions and, in short, an administrative protection whereas the common-law approach is principle-based and relies more on fiduciary duties and, at least ideally, transparency.

6 - One could note that the US also has very detailed and binding laws for its mutual funds (which are the equivalent of EU retail funds – the UCITS funds).

7 - There is no such model in the US, as it was only in 2010 when the Dodd-Frank Act was passed that registration of hedge fund advisors with more than \$150 mn in AUM was made mandatory.

8 - For hedge funds, the UK can be perceived as a country of exports, and the FSA is not perceived as police but rather as a facilitator; regulators in Luxembourg and Ireland have tried to set a similar role for themselves.

9 - The adoption of principle-based regulations is sometimes at odds with the civil-law approach – in the law code of countries, what is not explicitly forbidden is sometimes implicitly allowed. Because both approaches are inconsistent in ordinary law, such principle-based regulation can only be implemented in financial law.

## 4. The Directive and ESMA Implementation Advice

Our criticism of ESMA implementation is underlined by the notion that the AIFMD must be implementable at reasonable costs, and as such avoid redundancies. We have underlined that AIFMD is not mandatory for hedge fund managers. In addition, because regulated AIFs are not explicitly favoured in the regulation of institutional investors, these investors may prefer unregulated hedge funds to regulated AIFs. In addition, some specific hedge fund features – such as its variety and the entrepreneurial ability to launch new funds and strategy – should be respected (ideally in the conception of the AIFMD, not only by providing exemptions). So, on the whole, strong and credible yet inexpensive regulations are needed. In addition, we claim that insufficient attention has been paid to transparency and fiduciary duties: in the words of ESMA (2011, 43),<sup>10</sup> the AIFM should, in line with UCITS requirements, avoid malpractices such as market timing and late trading. So, fiduciary duties are in spirit copied from the UCITS directive which is, in our view, insufficient given the lack of homogeneity in practices and law enforcement across Europe.<sup>11</sup>

We successively review the questions asked by ESMA on depositaries, liquidity and risk management, transparency and distribution.

### a) Depositaries

The role of the depositary is now well-defined. Depositaries are responsible for cash monitoring, safekeeping of assets that can be safe-kept (and registry keeping otherwise), ensuring the segregation of funds, oversight for the calculation of net income and ensuring appropriate measures are taken if an auditor has doubts about annual accounts, by performing

due-diligence on sub-custodians.<sup>12</sup> The proposal in option 2 (ESMA, 315) for the definition of instruments to be held in custody could in the end lead to a clear framework. The depositary liabilities have been strengthened, with an inversion of the burden of the proof, and depositaries should be held accountable for loss of instruments that are held in custody in their network unless there are consequences of external events beyond reasonable control.

These principles are those that have finally been agreed after upon long discussions and clarifications regarding what can be considered an appropriate depositary liability. It should be noted that the directive and the ESMA consultation clarify how the depositary liability can be discharged. Discharge happens during the course of the contract, when a depositary has no other option but to delegate its custodial duties to a third party (e.g. as a result of legal constraints) or if it has a written agreement with the AIF that it is in the best interest of the AIF and its investors to delegate such duties (e.g. if the delegate is in a country where the depositary does not operate). The discharge can also be defined in the depositary contract if there is an objective reason for such a discharge. So, in theory, the directive and ESMA recommendations make it explicitly possible for the AIFMD to choose appropriate safe-keeping arrangements for specific asset classes. In practice, of course, there are still necessary clarifications to be made because the AIFMD may conflict with country laws: recall that in 2008, the UK bankruptcy code resulted in some assets held by Lehman being frozen, whereas at the same time French law required depositaries to return frozen assets immediately (see Amenc and Sender, 2010). The notion of events beyond control should be clarified.

<sup>10</sup> – Hereafter, the date is omitted for ESMA (2011) as this document is constantly cited.

<sup>11</sup> – More substance could be given to the requirement that the "AIFM should act in such a way as to prevent undue costs being charged to the AIF and its investors." (ESMA, 43)

<sup>12</sup> – Sub-custodians must, in particular, have segregated accounts.

## 4. The Directive and ESMA Implementation Advice

The work around the directive has also allowed the industry to gain a far better understanding of non-financial risks, particularly with the notion that different asset classes require different processes, both for the fund industry and for depositaries. We also believe that the important clarifications provided in AIFMD and ESMA advice are on the whole, workable, at least in the very context of a new regulated AIF – it would be much more complex to modify some existing contracts in UCITS or national alternatives, because many investment companies will find no reason to switch to less protective depositary contracts, and many depositaries will find no reasons to switch to more protective ones (depending on the situation). In addition, the requirement that when the depositary is “not satisfied with the level of protection and the AIFM has not taken any action despite its warnings, is to put an end to its contract with the AIF / AIFM” (ESMA, 186) is much more difficult to implement.

More fundamentally, the question of the depositary duties and regulations should have been detailed independently of the AIFMD, because it is not obvious that all regulated AIFs need depositaries. The check and balance role of the depositary is extremely important for UCITS funds and cannot be disputed. In the hedge fund industry, however, the administrator, the prime broker and the hedge fund themselves are often strongly involved in controls and risk management, so when imposing a depositary, one must strictly avoid redundancy of tasks. One should also avoid spelling unnecessary protection possibly not desired by investors if too costly. In other words, the objective set to “strike the appropriate balance between the Directive’s objective of ensuring a high level of investor protection” (ESMA, 136) may not be appropriate for all investors and all AIFs.

In addition, some of the traditional depositary controls may be inefficient in AIFs: complying with (supposedly lax) investment rules means nothing from a risk-management standpoint. With specialised investment strategies, the capacity that depositaries have to control is limited.

We thus argue that for professional investors, and thus for the AIFMD, the central responsibility of the asset manager should be reinforced by stricter and meaningful fiduciary duties, as well as appropriate governance arrangements (separation of roles and powers), elements which are still missing in the directive and ESMA recommendations as ESMA implicitly relies on the definition of UCITS – definitions that have proven too vague in practice. Also missing are ESMA’s powers of law enforcement and guidelines for a homogenous practical regulation of fiduciary duties in various countries.

### **b) Liquidity Risk and Management**

Hedge funds are where illiquid investments must be made. Thus a successful and attractive AIFMD should clearly make the case for illiquid strategies. Because these strategies are needed to meet the needs of institutional investors (see Amenc and Sender 2010), failure to grant them access to such strategies leads to the temptation of regulatory arbitrage, just as banks invested in opaque structured products that arbitrated under the Basel banking regulation.

The most basic principle for liquidity risk in AIFs is that investment in illiquid assets should be allowed, to the extent that the liability structure permits (by having long redemption periods and possible lock-ups), and to the extent that the AIF manages the residual mismatch risk. As such, we find that the combination of a principle-based

## 4. The Directive and ESMA Implementation Advice

approach to liquidity risk management and disclosure is particularly suited. So, ESMA was right to reject an overly prescriptive approach and to reaffirm the overarching principle that “investors should be able to redeem their investments in accordance with the AIF policy, which should cover conditions for redemption in both normal and exceptional circumstances, and in a manner consistent with the fair treatment of investors.” (see p285 and following).

ESMA, however, should insist on the importance of having an adequate liability structure for illiquid assets from the outset, and acknowledge that liquidity risk management is not solely about gates and redemptions, but also about the way that asset are managed.

We also think that closed-end funds are a natural way to ensure access to illiquid assets via an adequate fund liability structure. So, there should be a place for closed-end funds in the AIFMD. After all, Amenc et al. (2010) underline that closed-end funds, which would require a stronger governance framework, are a possible means of isolating and distributing illiquid strategies: by ensuring that liabilities have a long horizon, the fund can safely invest in less liquid assets. In addition, an AIFM could decide to turn an AIF from an open-end fund into closed-end funds as part of its liquidity management, but this possibility has not been considered by ESMA.

Not only do we agree on the need for disclosures, but we also insist on the necessary transparency on the risk that the assets turn illiquid. After all, one should recall that the 2008 crisis was partly caused by a lack of transparency on (potentially) illiquid assets.

### c) Transparency

Transparency, which together with fiduciary duties is an essential feature of principle-based regulation, is the weak link of regulatory initiatives, as we believe more attention is given to disclosures than to risk itself. As underlined in Branson (2006), too many bells and whistles can lead to unnecessary costs at the expense of true transparency.

If the regulation of retail funds can arguably emphasise protection, the protection needs of professional investors cannot come at any cost, and transparency about both financial and non-financial risks is what is most necessary for investors. At the end of the day, investors must not only know what risks they face, but they must also be able to quantify them.

Politicians gave priority to the AIFMD to tackling depositary issues yet, as the crisis has illustrated, the historical lack of transparency is an equally important problem. Communication on financial risks is poor,<sup>14</sup> but the lack of communication on non-financial risks as well as on illiquidity risk in investment funds has led to an unknown degree of actual protection against non-financial risks. This has been the case in UCITS, but the AIFMD and ESMA recommendations do not entirely correct this in AIFs.

We approve the ESMA recommendation (p278) that AIFs must specify the objective that risk management systems must achieve together with risk factors; regarding ESMA recommendation (Box 107, risk profile), we very much agree that disclosures on all *relevant* risks are necessary as a general guideline. Relevant should be understood as the potential risks or those that are, either economically or by construction, embedded in a product, not those that are most easily captured by historical

14 - They Key Information Document proposes a synthetic indicator based on volatility. Of course, this indicator is not relevant for non-linear payoffs, so a loss-based indicator like Value-at-Risk must be preferred – what truly matters to investors is how much they can lose in some adverse conditions.

## 4. The Directive and ESMA Implementation Advice

volatility (so risk is really about what happens in worst-case scenarios). Box-ticking and window dressing must be avoided, so relevant risks should be those that are ever-present in the fund, even if not at the reporting date. So, the more comprehensive disclosures and stress tests in option II seem more appropriate to us than those in option I.

Yet we think more efforts should be made on the quantification of risks as a basis for comparison between AIFs. What is missing is an aggregate measurement or notation about non financial risks. The ability for an investor (whether retail or professional) to assess risks from ad-hoc stress-tests and risk sensitivities communicated by the AIF should not be overestimated. And with an adequate quantification or rating (see below), smaller disclosures could be required of AIFs and the communication of stress-tests could become more secondary. As to how risk can be quantified, both depositaries and fund managers should have a responsibility in risk measurement. Let us consider the situation of asset managers and depositaries in turn.

Asset managers are the best placed to estimate financial and liquidity risks because they are the ones managing it. Yet they have no strong incentives to reveal the true extent of their risk, especially when box-ticking historical measurement of risk is allowed or even recommended.

At the same time, external approaches to risk measurement are difficult to implement, often because of conflicts of interest, and in the case of the hedge fund industry, because risk measurement requires a more intimate knowledge of risks taken – the holdings at the close of the period are not sufficient to assess risks when the AIF follows a dynamic approach. So, a possible solution is to give strong

incentives for a best practice set of tools to be used for risk assessment. The use of open solutions, such as Opera (Open Protocol Enabling Risk Aggregation), could allow for risk assessments and measurements that are *comparable* to a certain degree, as well as auditability. We recall that some respondents to the ESMA call for reaction pointed out (for instance regarding leverage) that “ESMA should provide some standard methodologies such as gross leverage, net leverage and ex-post volatility to allow for comparison of different AIFs by investors” (ESMA, 228).

Depositaries are in the best position to evaluate the non-financial risk that is generated by sub-custody, because they are close to this risk. They are partly responsible for it and are also involved in due diligence and collateral management operations.

Depositaries, however, lack incentives to display the actual risks they can measure in investment because investment managers are their clients. There must be clear, regulatory guidelines and incentives for them to display risk adequately. The AIFMD and ESMA recommendations give some incentive for disclosures of inadequate arrangements, but not for information that allows the quantification of risks, so this aspect should be reinforced.

As regulators have recommended a synthetic financial risk indicator, the same should be done for non-financial risks. Such an indicator, that would incorporate some of the information traditionally gathered throughout due diligence processes, could allow for lower costs of due diligence for professional investors (when these costs are redundant amongst investors).

### d) Distribution

Distribution seems to be the other forgotten leg of the AIFM directive, which now deals with most other aspects of fund management. It seems that, since distribution had already been tackled in a series of separate directives (MiFID, PRIPS), politicians did not feel the need to press regulators to incorporate distribution into their work on the AIFMD.<sup>15</sup>

Distribution incentives, however, have great importance in the decision to submit to regulations. So, with respect to unregulated funds, we argue (see Amenc and Sender, 2010a) that the regulation of professional investors (in particular of institutional investors) should be modified so as to favour regulated alternative funds. We also argue that because the regulation of distribution is here to ensure that adequate funds are distributed to adequate people, it must rely on transparency.

After all, there are numerous examples where inadequate products have been distributed – for instance real estate funds and money market funds that relied on potentially illiquid assets and on mark-to-model rather than mark-to-market valuation, which proved illiquid during the crisis (see Amenc and Sender, 2010b for examples). ESMA recommendations ensure that some of the liquidity risk is adequately communicated. Adequate, synthetic communication on non financial risks is still missing.

An important question not examined by regulators is whether the first line of defence and the responsible party for ensuring that adequate information is provided to clients should be distributors or the investment firm. In the former case, there would be clear incentives for distributors to require more comprehensive

information from investment firms and depositaries when such information is missing. In the latter case, the investment firm would be responsible not only for communicating information prescribed by regulators, but also for providing relevant information about all significant risks, whatever these are. On the whole, clarification of responsibilities would help ensuring that at the end of the day, information about risks is not withheld.

15 - In the ESMA recommendations, there is no reference to the distributor, and the only reference to the distribution channel is made to clarify the limitations of the depositary cash monitoring function : "ESMA has put forward advice with a view to clarifying that the depositary is not expected to interfere with the distribution channels of the AIF but simply to verify the information at the level of the AIF's register" (p136) and "limit[s] the depositary's verifications to the information stemming from the AIF's register" (...) "because the depositary is not necessarily aware of each and every potential distribution channel" (...) which "put[s] the focus on the entity which centralises the subscriptions" (p151).

## Conclusion

The AIFMD started as a politically-driven regulation without clearly defined objectives, such as the ones set in UCITS – a regulation that has been a historic success despite recent setbacks. The AIFMD has had large improvements, and in particular has proposed a globally viable definition of depositary duties.

An ambitious objective for the AIFMD would be to provide a framework attractive enough for fund managers to submit to this regulation – remember that alternative funds can submit to UCITS regulation (as NewCITS) or remain unregulated hedge funds. As such, there should be clear distribution incentives, so the regulation of institutional investors should favour regulated funds over unregulated ones.

Together with distribution should come transparency. To avoid a box-ticking approach, a principle-based approach is necessary. Risk quantification is also important, and may help in avoiding too many, yet opaque disclosures.

On the whole, a generic directive for hedge funds (managers) must walk on the tight rope, reassuring investors without penalising them by unnecessary costs, ensuring independent and external controls are made possible, while at the same time keeping the fund managers in the driving seat. In fund regulations, the asset manager (or the asset management company) has the central responsibility, and regulations should enforce that responsibility by giving them strong fiduciary duties. We believe that the ESMA recommendations are insufficient to ensure that, in practice, the meaning of fiduciary duties, their enforcement and legal interpretations are harmonized in Europe.

Lastly, because regulations are costly to implement, the expectations and

preferences of the fund management industry and of its clients should be made clear. As we believe the best way to achieve this is by means of a survey of the profession, EDHEC-Risk institute, with the support of CACEIS, has launched a survey where the profession will assess the options available for each relevant category of regulation: transparency, governance, capital protection and financial responsibility, distribution, restitution of assets and judicial powers of investors.

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