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Keynote speech by Verena Ross, Executive Director of ESMA, at the London AIMA Annual Conference, 22 September 2011

Ladies and Gentlemen,

I am very pleased to have the opportunity to speak at your annual conference today. It is a great pleasure for me to speak for the first time at your annual meeting and doing so in my new capacity of Executive Director of ESMA.

As you are all well aware, this is a crucial time for alternative asset managers given the new AIFMD framework which the industry will have to adapt to in the forthcoming months in order to be prepared by July 2013. Of course, this is a crucial time for ESMA as well since we are due to deliver our advice to the Commission by mid-November in order to allow the latter to finalise the Level 2 measures by next summer.

Before discussing the main aspects of the AIFMD, I would like to say a few words about ESMA and to mention some other pieces of EU legislation which may also be quite relevant for the hedge funds industry.

Starting with **ESMA**, I would like to stress that since its creation at the beginning of this year as a new EU independent authority, a considerable amount of work has already been done in order to ensure we meet expectations. Due to the transition from CESR to ESMA, our internal organisation has been restructured and ESMA has now different divisions and units better reflecting tasks such as policy making, direct supervision of CRAs and research on financial market trends and stability issues.

In addition, the regulation establishing ESMA enhanced the consultation tools available providing for a Securities and Markets Stakeholders Group (SMSG), which was appointed last May by ESMA's Board of Supervisors. The SMSG replaces the market participants consultative panel that existed under CESR and is composed of 30 members serving for a period of two and half years. It ensures input to ESMA's work from a large spectrum of stakeholders since not only the industry (and different parts of the industry), but also consumers and academics are present within the group.

The SMSG will support us with advice and assistance on the different tasks ESMA is entrusted with: in particular, SMSG will give advice on the draft technical standards and guidelines and recommendations that ESMA may adopt and on which I will say a few words shortly.

Before doing that, I would like to stress that all our activities are part of an effort aimed at fostering European regulatory convergence through the new European System of Financial Supervision which was set up at the end of last year and includes the other two European Supervisory Authorities (ESAs), i.e. the European Banking Authority and the European Insurance and Occupational Pensions Authority. The new ESAs shall indeed closely cooperate under the Joint Committee in order to foster a harmonised approach both among regulators and across financial sectors.

Within this framework, the overall stability of the European financial markets is the key objective of the European Systemic Risk Board (ESRB) which is responsible for the macro-prudential oversight of the European financial system and with which the ESAs closely cooperate.

At this stage, I would like to provide you with an overview of what ESMA can do and the powers we have. When looking back at CESR, the two main differences that I would highlight are that (i) ESMA has been entrusted for the first time with direct supervisory powers on CRAs and (ii) as regards its policy making activities, it may now issue draft legislative texts, the so-called technical standards, with a binding power for supervisory authorities and market participants (once endorsed by the Commission).

Indeed, whereas the on-going supervision of market participants generally remains with the national competent authorities, the new CRAs Regulation provides for direct ESMA supervisory powers on the registration and supervision of CRAs in Europe. In addition, you will be aware of another legislative proposal which is likely to provide ESMA with some direct supervisory functions: indeed, according to the EMIR proposal, ESMA will, inter alia, be responsible for the supervision of trade repositories. And it cannot be excluded that other pieces of legislation could in the future entrust ESMA with other similar supervisory powers over pan-European entities in certain specific fields.

The second substantial change that I just mentioned relates to the entire new set of legislative instruments available to ESMA, in particular the possibility not only to issue advice to the Commission (as was the case under CESR), but also to draft technical standards with a legally binding power that are then formally adopted by the Commission. Each new legislative proposal in ESMA's field of competence sets out the areas where ESMA may or shall make use of such legislative powers.

Beyond this, ESMA may issue guidelines and recommendations without a legally binding effect, but requiring national authorities to confirm whether or not they comply with the rules established therein and, in case of non-compliance, the national authorities have to explain the reasons.

Given these tools, I would like to highlight the five priorities on which our work will focus in our first years of activity. The first one is the building of an effective pan-European supervision of CRAs; the second is the contribution to the drafting of the European single rule book in the financial sector (also through the various new legislative instruments that I mentioned earlier); the third relates to the growing efforts for

enhancing consumer protection (an area where we have been given powers not only to issue warnings to investors and consumers, but also where we might consider potentially banning specific products and/or activities); the fourth is the cooperation with the ESRB and the other ESAs on the monitoring and assessment of systemic risks; finally, the fifth concerns the role that we are going to play to reduce and progressively eliminate regulatory arbitrage across Europe.

Now, as anticipated, before entering into details on the AIFMD, I would like to say a few words about a number of legislative measures, mainly on **OTC derivatives**, which may have an indirect impact on the hedge fund industry.

Firstly, as a result of the G-20 commitment to reform the OTC derivatives markets by the end of 2012, the **EMIR** proposal assigns a considerable role to market infrastructures. Indeed, central counterparties will centralise the clearing of all standardised OTC derivatives traded by both financial and certain non-financial firms, which is expected to bring greater safety in the market through the reduction of counterparty and operational risks. It is also expected that increased transparency will be introduced in the market through the reporting obligations to trade repositories, which will be accessible to all relevant authorities.

In this context, ESMA's supervisory role will ensure unfettered, fair and open access to trade repository information.

Another crucial role ESMA will play in the functioning of the new system will be to identify the standardised OTC contracts to be subject to the clearing obligation.

We also expect to be given a strong coordinating role in the colleges of national authorities supervising central counterparties operating on a cross-border basis.

As EMIR is being finalised and ESMA is starting to think about the binding technical standards it needs to formulate (nearly 30 on EMIR alone), the US authorities are also finalising their rule making under the Dodd-Frank Act. We are therefore, together with the Commission, working with the US to solve any potential extraterritoriality issues that might pose problems to the global nature of the derivatives market.

Moving on to the **MiFID review**, this initiative may introduce significant changes to the OTC derivatives markets coming from the G-20 commitment that I mentioned before. As you know, the Commission published in December 2010 its consultation on the MiFID review where it proposed that all trading in derivatives which are eligible for clearing and sufficiently liquid shall indeed move to regulated markets, MTFs or other organised trading facilities. According to the Commission's consultation, ESMA can be expected to play several roles in this area, not only in delivering the usual advice to the Commission for the

development of Level 2 measures and in drafting the relevant technical standards, but also in determining whether a clearing-eligible derivative is also sufficiently liquid to be traded on organised trading platforms.

MiFID obviously covers a much wider range than this specific issue, but reflecting on all the different areas covered by MiFID would be enough material for another full speech.

Let me also mention a last initiative which may be of interest to your industry: the Commission proposal on **short selling and CDS**. Over the summer ESMA coordinated national authorities' efforts in taking measures on short selling during a period of very high volatility in the financial markets; this work was conducted in the absence of any EU common regulatory framework in the area of short selling.

The new proposal, once adopted, will ensure greater transparency through the introduction of a regime for notification to regulators of significant net short positions (including CDS) in EU sovereign bonds. A considerable step forward, as compared to the current system, is the introduction of harmonised powers for national competent authorities to impose temporary measures in exceptional situations.

ESMA will see its coordinating role made official in exceptional situations since national authorities will have to notify us of the measures they intend to take in advance of their adoption; in certain limited circumstances ESMA may also itself take action, which in such a case would prevail over any measure adopted by national authorities.

Coming to the **AIFMD**, which I know is a subject of much interest for you all, as I mentioned at the beginning of my speech, we are currently working very hard to deliver our advice to the Commission within the challenging deadline of 16 November.

The consultation on our draft advice closed recently and we received a great many responses (over 100 responses). I would like to thank AIMA and all of you who submitted an individual response for your valuable input which is helping us in finalising our advice. I also wish to express our thanks to the high number of participants who attended and provided valuable comments at the open hearing held on 2nd September.

As you know a separate consultation on supervision and third countries is still running and the deadline for submitting to us your written comments is tomorrow (23 September). A second open hearing on this topic will be held on Monday 26 September and I encourage you to participate also in that event. The feedback received on both consultations will be taken into careful consideration when elaborating our final advice to the Commission.

The overall approach that we have taken when preparing our draft advice for the Level 2 implementing measures, in particular the first part relating to the general operating conditions, has been to align to the extent possible the AIFMD rules to the already well-defined framework set out under the UCITS directive and MiFID. Of course, we have done a lot of work to tailor the relevant provisions of these two directives to the alternative investments sector, bearing in mind that the UCITS directive relates to retail-oriented funds. Indeed, we are very conscious of the fact that the AIFMD was drafted with a focus on marketing to professional investors (as defined under MiFID) and it is without prejudice to any stricter measures that member states may decide to impose whenever the marketing of an AIF to retail investors is foreseen.

Appropriate tailoring has been relevant more generally in the sense that different requirements will be introduced depending on the type of AIFM/AIF concerned. Indeed, the Commission specifically asked us to take this into account when preparing our advice. On this specific topic, which we know is of utmost interest for the industry, we will be particularly careful in analysing the feedback we received to our consultation.

This is linked to the technical standards that we will have to prepare under article 4(4) of the AIFMD in order to determine the different types of AIFM which are relevant for the purposes of the application of the directive. Although this is a separate piece of work which is not covered by the Commission's request for advice, it will be an important part of the overall package of implementing measures. You will of course have the chance to express your views on our proposals in this area in the coming months.

Moving forward to the main topics of the AIFMD, I would like to start mentioning some areas which I know are of particular concern to the industry and which we will have to consider carefully when comparing pros and cons of the different solutions. For the sake of time, I will only mention four areas today but we know that others may be generating a certain level of debate and discussion.

The first one relates to the requirement for the AIFM to have **additional own funds** or **professional liability insurance** to cover professional liability arising from negligence. I know that the industry is concerned that the potential difficulties in finding insurance in the market, will effectively force AIFMs to comply with the additional own funds requirement, whereas according to the text of the directive two options should be available to them. However, these requirements have been established at Level 1 and we are required to advise the Commission on methods for calculating the respective amounts of the additional own funds or the coverage of the insurance.

Two alternative options are envisaged for the calculation of the additional own funds: the first one is based on the variable assets under management whereas the second also takes into account the variable income. When choosing either of the two options, one aspect that we will consider carefully is the extent to which there is a link between the income an AIFM receives and the risks to which it is exposed.

Secondly, on the **depositary** side, which is probably one of the most hotly-debated topics of the AIFMD, we need to bear in mind the constraints at Level 1 and the very difficult technical issues involved on both the depositary's duties and the liability regime.

There are some concerns regarding the approach taken to depositary liability, and in particular whether the insolvency of the sub-custodian should be considered an 'internal' event (thereby triggering liability of the depositary). However, there is some evidence of a split of opinion on this issue between depositaries on the one hand and asset managers on the other (the latter generally being more in favour of a strict approach to the depositary's liability). There are also fears that ESMA's proposed approach could lead to an over-concentration of entities in the market. These are important issues for us to consider in the finalization of the advice.

There are particularly vocal requests for tailoring of the provisions on this part of our advice; for instance, private equity representatives call for tailoring of the rules to fit more appropriately their activity. In particular, there are some concerns regarding a possible ex-ante role for the depositary that could potentially interfere with decisions of the investment committee, or even have an impact on the liability of limited partners (i.e. liability could be transferred to the depositary). It goes without saying that all the concerns expressed by the industry on this topic as well as on all the other parts of our draft advice will be taken into due consideration in our work over the next two months.

Thirdly, I would like to mention the provisions on **leverage**, which, I am sure, are of particular interest to hedge fund managers. The directive sets out specific rules on leverage in terms of disclosure to investors, but also in terms of powers granted to competent authorities to monitor the use of leverage and, if necessary for the prevention of systemic risk, to limit it following a specific procedure.

ESMA will have to play a central role in such a procedure since it is required to perform a facilitation and coordination role vis-à-vis national authorities who have taken measures restricting AIFM's use of leverage. ESMA may also issue advice requiring competent authorities to take measures, including limits to the level of leverage, whenever the use of leverage by AIFMs poses a substantial risk to the stability of the markets.

In developing our draft advice on the methodologies to be adopted for calculation of leverage, we have taken our guidelines on risk measurement and the calculation of global exposure for UCITS as a reference: thus we have set out two mandatory methods ('gross' and 'commitment' methods) for calculating the exposure of an AIF; in addition, we have introduced a third method which may be adopted subject to the condition that neither of the two mandatory methods is accurate for a specific AIF, given its investment strategy or the nature of the assets in which it invests.

When making our final determinations we will take into account the views expressed by some that the gross method is not appropriate and is not in fact a measure of leverage.

Fourthly, I would like to run through the key provisions on **third countries**, which, as I mentioned earlier, are subject to a separate consultation ending tomorrow.

The AIFMD sets out a global framework for the distribution in Europe of EU and non-EU alternative funds managed or marketed by both EU and non-EU managers. The system provides for a passport regime based on a notification procedure which shall gradually be introduced and is expected to work similarly to the well-established UCITS passport.

The timeline on the third country provisions is quite complex and it may be worth to recap the main principles governing the new regime.

Until 2013, the existing national private placement regimes shall continue to govern the distribution in Europe of EU and non-EU AIFs marketed by EU or non-EU AIFMs. Once the transposition period has elapsed, EU AIFMs will benefit from a passport to market EU AIFs to professional investors across Europe and the national private placement regimes will be phased out.

For a transitory period from 2013 to 2015, non-EU AIFs managed by EU AIFMs and non-EU AIFMs marketing EU and non-EU AIFs may carry out marketing under the national private placement regimes, subject to some requirements set out in the directive. In 2015, a passport regime is expected to enter into force for such kind of marketing, subject to the issuance of positive advice by ESMA and to the adoption of a delegated act by the Commission. Then the two regimes are expected to coexist until 2018 when the Commission is expected to adopt a separate delegated act (subject again to ESMA's positive advice) phasing out the national private placement regimes and so introducing a full passport for any AIF marketed in Europe. These rules shall of course apply to the marketing to professional investors only – as I mentioned earlier, the AIFMD explicitly states that the marketing to retail investors of EU and non-EU AIFs may be allowed by member states under stricter requirements.

For these passport and private placement regimes to be used, the concerned EU regulator and the authority of the third country will have to put in place specific cooperation agreements. Our advice will focus on the content of these cooperation agreements. Moreover, the Commission has invited us to consider how ESMA could assist EU regulators in putting in place the agreements with the third country supervisory authorities.

Indeed, it would clearly be more efficient to have a single agreement negotiated by ESMA and then endorsed by the EU regulators (or signed by ESMA on their behalf) than having 27 national authorities each negotiating a separate agreement. Of course, the legal issues related to the signature of the

agreements either by ESMA or by the national authorities will have to be analysed. In any case, there is a role for ESMA to play also in the establishment of a framework for the third countries provisions.

Our work on the third country issues, is not limited to the cooperation agreement, but we are also providing advice to the Commission on other matters, such the identification of the 'member state of reference', which, according to the directive, is the member state from which non-EU AIFMs intending to market AIFs they manage in the EU with a passport must acquire prior authorization. We are also addressing the third-country aspects of the provisions on delegation and depositaries.

Coming to my final point on the AIFMD, I would like to highlight that our November advice to the Commission will include not only the topics covered by the first consultation, but also the full set of third countries provisions. Indeed, although the fact that certain of the implementing measures relating to third countries are less urgent since they relate to the introduction of the third country entities' passport (which will not be effective until at least 2015), the cooperation arrangements with the third country supervisory authorities referred to under certain of the implementing measures have to be in place by July 2013 (i.e. the AIFMD transposition deadline). Therefore, the implementing measures relating to the third countries must also be adopted by July of next year.

Finally let me briefly comment on how all this work in Europe relates to the work at the global level. Until I took up my current position, I co-chaired for the ESA together with Nicoletta Giusto from the Italian Consob, the IOSCO Hedge Fund Task Force. At global level we looked specifically at issues related to the potential systemic impact of the hedge fund industry and proposed and trialed a global hedge fund survey. This was done to allow securities regulators globally to gain an insight and collect data on the trading strategies, activities and leverage of global hedge fund players.

If it is difficult to get to common approaches in Europe, you can imagine that trying to get to a common global approach is not an easy task. But I believe we managed to progress in a way that will – at least in terms of some of the data collection on activities and leverage in AIFMD – achieve some consistency across the globe, given the active and positive participation of regulators from for example the US, Hong Kong and Switzerland in the IOSCO exercise.

Coming to the **conclusion** of my intervention, I think that the topics I have covered today demonstrate that the industry needs to have an increasingly horizontal view of global regulatory changes. For instance, if it is true that for the alternative investment industry the interest is focused on the new AIFMD world, other legislative measures such as the EMIR provisions, the new MiFID rules and the rules on short selling and CDS also have potentially significant consequences. It is an even bigger challenge for us as regulators to ensure consistency in the overall regulatory review.

This means that the changing regulatory landscape entails big challenges for all of us.

We at ESMA, as the European regulator, have to decide how best to make use of our new supervisory and policy making powers; indeed, we have to find the right balance between investor protection and financial stability, on one side, and understanding the potential impact that any measures adopted may have on the effectiveness of the European financial industry, on the other.

You, as representatives of this industry, face the great challenge of adapting your well established business models to the new rules which are being adopted in ever greater numbers, mainly as a consequence of the financial crisis.

I hope that we may continue working together to improve the credibility and stability of the financial sector.

Thank you for your attention.