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UNIVERSITY | NEWARK

Rutgers Business School
AIS Department
Continuous Auditing Laboratory
Newark, NJ

https://raw.rutgers.edu/public_interest.html
kevin.moffitt@business.rutgers.edu

ESMA Brief - 2011

Strengthening Risk Management and Governance Structures in AIFM (governance)

ESMA advocates for AIFM (Alternative Investment Fund Managers) to strengthen their governance structures and risk management, emphasizing the importance of proportionality, operational structure, and corporate governance. The risk management function should be functionally and hierarchically separated from the operating units. ESMA also proposes a documented risk management policy that includes justifications of risk limits, details on risk management responsibilities, risk management techniques, safeguards, and reporting frequency. Governance arrangements should be robust and include suitable systems and methodologies for managing diverse risk situations. The assessment of these arrangements may be built upon several factors such as operational structure, corporate governance, cost-benefit analysis, staff competency, and investor expectations. Additionally, ESMA recommends transparency and accountability of private equity activities for the interests of all stakeholders, and states that the depositary's governance, monitoring, and oversight functions are crucial. The responsibility of the depositary should aim to achieve an outcome instead of best-effort undertaking. Despite varied national regulatory approaches, it is essential to align the risk profile disclosed to investors with the actual risk profile for AIFM.

Risk Management Measures and Approaches within the AIFM Framework (environment)

The AIFM framework mandates the use of historical internal loss data, and where applicable, external data, and scenario analysis for risk management. All these factors reflect on the business environment and internal control mechanisms. Authorities assess the efficiency of these systems using various criteria such as operational structure, corporate governance processes and risk management function. Furthermore, it considers marginal benefits to investors, staff competence, and investors' expectations of risk management changes.
There is a general consensus against a rigid model agreement, favouring adaptability across various business models and environments. However, this could lead to inconsistencies between directives and administrative burden. ESMA is tasked with specifying conditions for efficient cash monitoring and performance of depositary functions. Also, it addresses potential risks of having a lower degree of harmonization.
Effective risk management remains the responsibility of AIFM, with the depositary’s duties lying in assessing the control procedures and environment. The risk management function should be able to integrate changes in investment strategies and adapt to a dynamic business environment.

Risk Management and Fraud Prevention in Investment Associations. (fraud)

The investment management association expressed that many sub-custodians could be unwilling to assume liability beyond their own fraudulent acts or negligence due to existing third-party right laws and other potential difficulties. Senior management is expected to establish and maintain procedures to prevent fraudulent actions and ensure proper asset valuation. Liability issues may arise if the AIFM negligently violates AIF rules or fails to conduct sufficient due diligence on risky investments. Operational risks include the failure of information technology connecting AIFM to the market, key personnel departure, reconciliations performed by fund administrators, fraud, and trading and settlement failures. Special attention should be paid to financial offences, fraud or financial crimes when evaluating negative records. The depositary's duties include ensuring proper registration and maintenance of financial instruments, conducting regular reconciliations, evaluating custody risks, and creating organizational arrangements to minimize risk. The depositary should also notify AIFM of any significant identified risk and ensure that any loss from fraudulent behavior is included under their liability. Fraud reduction would enhance investor protection. There is also a call for restricting the AIFM's liability to risks from negligence only and not fraudulent risks.

Analysis of Operational Risks and Technology Costs in Financial Markets (technology)

The European Securities and Markets Authority (ESMA) primarily focuses on certain instances of operational risk, including IT failure, key personnel exit, failure in investment reconciliation, fraud, trading and valuation services failure. Introducing new system architectures and processes would considerably exceed the current technology budget, requiring duplication of some middle office functions, significant additional technology investment and substantive changes in interactions between depositaries and fund managers. Innovations include developments driven by technology, like high frequency trading, fee structures, sponsored access and tick size regimes. However, ESMA also warns about the adverse effects of technology, emphasizing potential information asymmetries created for informed traders who don't process information as fast as certain firms. Despite costs and risks, the trend towards a more technology-driven order processing system and the emergence of new related risks continues.

Adapting Regulatory Approaches in the AIFM Industry (business model)

Businesses in the AIFM industry require adaptable regulatory models to accommodate diversity, size, and diverse business structures. There's a risk associated with too restricted options and regulatory limitations, resulting in an inability to harmonize across various business models and legal environments. Options such as creating a model agreement or offering no agreement provide different benefits and costs. A model agreement allows for higher harmonization and legal certainty but limits flexibility, whereas no model agreement maintains adaptability but risks lower harmonization. A common thread amongst stakeholders is the need for regulation to consider and align with the diversity and complexity of different AIF business models. This demonstrates the need for regulatory approaches that are proportionate, adaptable, and flexible to different business models, sizes, and types of AIFM.

Confidentiality Compliance and Consequences of Breach in Investment Entities (confidentiality)

The principal interest here is the legal and regulatory obligations relating to confidentiality within the operation of Alternative Investment Fund Managers (AIFMs) and credit rating agencies. These entities are tasked with safeguarding the security, integrity, and confidentiality of significant amounts of sensitive and proprietary information. There are serious potential liabilities if these duties are breached, ranging from the loss of documents and title to investments to the inaccurate representation of information. The use of nominee names for asset registration could also lead to breaches in confidentiality. To avoid these issues, AIFMs must establish and maintain comprehensive systems and procedures, ensuring high levels of security in electronic data processing. Regulatory frameworks, corporate governance, and organisational accountability all play key roles in ensuring compliance, with strict directives set out under EU regulations for individuals involved in credit rating activities. Any breaches can potentially impact market organisation and necessitate amendments to incorporation instruments and established regulatory agreements.

Impact and Role of Financial Innovations on Base Prospectus Regime (innovation)

Respondents generally expressed concerns about the European Securities and Markets Authority (ESMA)'s proposal to set an exhaustive list of information items for final terms. They believe this may decrease flexibility in the base prospectus regime and limit financial innovation, while not granting additional benefits to investors. Furthermore, they indicated that outlining all possible pay-outs in base prospectus could diminish financial innovation and render certain financial instruments impracticable. However, ESMA disagrees, stating that financial innovation won't be strongly hindered as issuers can always prepare a prospectus. Respondents also questioned ESMA's reasoning for including issuer-composed indices in the base prospectus, citing complexities around all indices rules and the client demand and market innovation driven criteria for proprietary indices. Despite this, ESMA decided to retain the current classification of issuer-composed indices.
ESMA recognizes the need for innovation flexibility and disclosure regulation in financial products development. Still, it acknowledges that traditional national supervision models have struggled to keep pace with financial innovation, signifying a focus on cross-border, cross-sector, and financial innovation considerations.
The high-frequency trading (HFT) phenomenon is identified as a key financial innovation, driving competition and technology advancement among trading venues. Some respondents believe the HFT practice will grow due to reduced technological costs and regulatory innovation. Despite various concerns and suggestions, ESMA aims to ensure innovation flexibility while regulating information disclosure, putting less focus on the appropriateness of product offerings.

International Audit Standards for AIFM Marketing Non-EU AIF (auditing standards)

The directive allows member states to let AIFM market non-EU AIF, with annual reports subjected to auditing that aligns with the international standards of the country where the AIF are established. Essential financial information includes a balance sheet, income statement, equity changes, cash flow statement, and accounting policies. This information must be independently audited or reported to provide an accurate representation according to auditing standards in a member state or equivalent. In the case of any departures from international standards, clear disclosure of the auditing standards and any deviations must be included in the prospectus. The paper also discusses the definition of materiality in auditing standards and its potential difference from that in International Financial Reporting Standards (IFRS), noting that auditing standards focus on the potential misstatements and omissions that could influence the economic decisions of users. Lastly, the paragraph suggests a proposed amendment which contrasts with international disclosure standards set by the International Organization of Securities Commissions for cross-border offerings and initial listings by foreign issuers. This amendment points to a document with comparative financial statements for the latest three financial years, audited according to a comprehensive body of auditing standards.

Global Standards Application and Adoption in ESMA Regulations (international standards)

The ESMA (European Securities and Markets Authority) strategy revolves around introducing regulations based on international standards while considering specific features of the AIFMD (Alternative Investment Fund Managers Directive). Key standards under focus include IOSCO (International Organisation of Securities Commissions) guidelines related to supervision, cross-border monitoring and exchange of information. ESMA is optimistic about the use of international standards as benchmarks. To maintain consistency, the alignment of their regulations with other international standards and EU legislation is being emphasized by respondents. Furthermore, transparency is being sought through harmonized prospectus disclosure for mineral companies that align with international norms. ESMA is also proactive in monitoring developments in accounting and auditing regulations. Consequently, ESMA has confirmed its reliance on international norms following broad support received from respondents.

Enhancing Private Equity Transparency and Infrastructure Integrity for Efficient Market Operations and Stakeholder Assurance (accountability)

The paragraph emphasizes on the need for increased clarity and public accountability in private equity dealings, which will accommodate stakeholder interests, decrease information gaps, and improve market efficiency. Other crucial considerations mentioned include the strength of the financial market, management reputation, regulatory compliance understanding and accountability, and operational infrastructure. Bringing focus to third-party custodial activities, the need for insurance coverage, vault capacity/security, and providing access to pertinent data are also considered necessary. The implementation of a documented procedure when selecting sub-custodians and the emphasis on the annual report as an instrument of accountability are discussed.
There is an intended shift towards developing electronic trading systems which embed risk management frameworks and adhere to regulatory compliance. The document enumerates requirements to ensure system capacity, business continuity arrangements, security measures, testing methodologies, and skillful staffing for these systems. The paragraph concludes by stating that primary users may use financial reports to evaluate stewardship and accountability while making economic decisions.

Evaluation and Regulation of Internal Controls in Financial Institutions and Investment Firms (internal controls)

The focus is largely on the assessment of sub-custodian practices, procedures, and internal controls to ensure careful handling of financial instruments. Concerning decisions on leveraging, the importance of better disclosure and robust internal controls is highlighted to avoid harming investors' interests. Furthermore, the importance of managing operational risks through robust governance arrangements, internal controls, and reporting systems, especially in electronic trading, is stressed. Additionally, the regulation of DMA and SA services, the need for pre-trade controls, and risk management measures are mentioned. Lastly, the discussion covers regulatory requirements for credit rating agencies (CRAs), emphasizing the importance of not compromising the quality of internal controls or the ability of regulatory bodies to supervise CRA compliance through outsourcing.

Ensuring Proper Compliance Management in AIFMs and Investment Firms (objectivity)

The main focus is on structuring a proper compliance function within AIFMs and investment firms for adequate independence and efficiency. Key conditions that need to be met include having necessary authority, resources, skills, and access to relevant information. A designated compliance officer must be accountable for this function and must report regularly to the top management. Persons engaged in the compliance function should not be involved in the activities they oversee, and their remuneration shouldn't compromise their impartiality. It is also vital to set stringent controls that ensure a suitable level of objectivity when considering values from external sources. Conflict of interest management requirements of the EU regulation need to be satisfied in order to maintain the objectivity, independence, transparency and integrity of activities, while safeguarding the interests of investors and financial markets.

Understanding Materiality and Its Application in Financial Reporting (accounting estimates)

The concept of materiality plays a significant role in shaping financial reports and how they are interpreted. Entities are required to present material classes of similar items separately in their financial statements, and if the items are not critically material enough for separate presentation, they may be included in the notes instead. The International Financial Reporting Standards (IFRS) have provisions that exempt disclosure of specific information if it is deemed immaterial. There's also a prohibition against intentional departures from the IFRS to achieve a specific presentation if these departures are deemed immaterial. Additionally, financial statements are considered non-compliant with the IFRS if they contain either material or intentional immaterial errors. Materiality, in the assessment of an item for interim financial reporting, is judged against interim period financial data. Lastly, the ramifications of material omission or misstatements can lead to issues like issuance of new financial statements, communication to the public about the error, and correction in the subsequent financial statements. Changes in accounting estimates and discrepancies in policies are also noted and handled as per the Indian Accounting Standard (Ind AS) and the IFRS guidelines.
