

**EFAMA REPLY TO
CONSULTATION PAPER ON ESMA'S DRAFT TECHNICAL ADVICE TO THE EUROPEAN COMMISSION
ON POSSIBLE IMPLEMENTING MEASURES OF THE ALTERNATIVE INVESTMENT FUND MANAGERS
DIRECTIVE**

EFAMA¹ welcomes the opportunity to reply to ESMA's Consultation Paper on ESMA's Draft Technical Advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive.

Developing advice regarding implementing measures for such a broad universe of AIF and AIFM is an extremely challenging task and EFAMA wishes to congratulate ESMA on the quality of the advice issued under very tight time constraints.

EFAMA particularly welcomes that throughout its advice, ESMA sought consistency with the existing UCITS and MiFID framework while ensuring that rules are appropriate and proportionate for the specific circumstances of the AIFM and the AIF as well as their investors.

In addition to answers to the specific questions raised by ESMA, EFAMA in its answer to each Part and regarding the different boxes also raises general concerns and comments. Furthermore EFAMA allows itself to submit a number of general comments which apply to the entire proposed advice.

¹ EFAMA is the representative association for the European investment management industry. It represents through its 26 member associations and 56 corporate members approximately EUR 13.5 trillion in assets under management, of which EUR 8 trillion was managed by approximately 53,000 funds at the end of 2010. Just under 36,000 of these funds were UCITS (Undertakings for Collective Investments in Transferable Securities) funds.

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General Remarks

In addition to the answers to the questions raised in the Consultation Paper, EFAMA would like to submit a number of general remarks.

Consistency with the existing EU frameworks

EFAMA highly appreciates the approach adopted by ESMA to ensure the greatest possible convergence with the current UCITS and MiFID standards in implementing the AIFMD rules.

Many AIFM also manage UCITS funds or provide MiFID services. They will be authorized not only as AIFM but also as UCITS Management Companies and as MiFID firms. For these managers, a consequent alignment of the relevant EU regimes is crucial and very welcome because it is the only feasible way to provide for a consistent framework for fund managers offering a full range of asset management solutions.

This being said, EFAMA welcomes that adequate adjustments and differentiation must be made to take the difference between the UCITS funds and AIFs managed into account.

Limits of ESMA's Mandate

EFAMA considers that ESMA should not go beyond the mandate initially received. ESMA has received mandate to advise the European Commission about implementing measures to the AIFMD. However, some of the proposals in the draft technical advice go beyond what the AIFMD itself requires. EFAMA believes that ESMA should respect the initial requirements and not further tighten them, as for example in Box 19 or regarding Delegation or in its advice on Transparency Requirements.

Implementing Measures for AIF for professional investors

EFAMA would like to remind ESMA that the AIFMD has been drafted to regulate all non-UCITS funds and to provide a European passport for marketing to professional investors. The benchmark of regulation was aiming at regulation for funds for professional investors. The AIFMD leaves it to national legislators and regulators in the Member States to prepare stricter provisions for funds for retail investors at national level.

EFAMA considers that this approach should also be followed in the preparation of the Level 2 measures. The measures should be drafted to provide a minimum regulation for non-UCITS for professional investors. Any stricter provisions to regulate funds for retail investors should be left to the discretion of the Member States.

Against this background, a number of provisions in the ESMA draft technical advice, in particular regarding Transparency, seem too strict and should be redrafted.

Inclusion of Explanatory Text into Boxes

EFAMA welcomes the very helpful, detailed and precise information provided in the explanatory text throughout the Consultation Paper.

On the other hand, EFAMA feels that the text in the boxes in some instances is lacking clarity and the relevant information is provided in the explanatory text only.

This is for example the case for provisions which should be applicable to specific asset classes only. The limitation itself or the asset classes concerned are only mentioned in the explanatory text. Another example is the indication in the explanatory text of a proportional application of certain requirements which again is not reflected in the boxes.

In some places in the explanatory text criteria are mentioned to further clarify certain text. In instances where these criteria should only be seen as examples for the purpose of clarification, and not be exhaustive, they should not be included in the text box.

In order to avoid confusion or diverging interpretation in the future, EFAMA strongly suggests including the relevant explanatory text into the boxes.

Principle Based Approach

EFAMA understands that due to the fact that the AIFMD will be covering a highly diversified universe of products, it might be difficult to clearly define exact rules for all possible circumstances. In particular, it will be very difficult to define rules taking into account all kinds of assets AIF may invest in and the very different legal nature of AIF to be set up (open-end /closed-end, contractual or corporate type).

EFAMA would therefore suggest keeping rules principle based where possible and allowing for a proportionate and differentiated application. A rule based approach can be taken, but should then be either generic enough to cater to all possible situations or should be clearly signposted in the box for a defined type of AIFM or AIF or assets.

Proportionality and Differentiation

In several parts of the Consultation Paper ESMA underlines that requirements should be applied proportionally to the size of the AIFM, the amount and type of assets it manages and the complexity of its activity. EFAMA welcomes the application of the proportionality principle in these instances.

However, in various parts of ESMA's draft technical advice, proportionality and appropriate differentiation of requirements have not yet been included.

EFAMA invites ESMA to reflect the proportionality principle and provide for an appropriate differentiation of requirements throughout the entire set of implementing measures, and in particular regarding the General Operating Conditions and Transparency. For example many organisational requirements or the provisions relating to risk management should only be applied in a proportionate manner. Another example are the reporting obligations in Box 109 which is currently imposing a uniform set of strict reporting duties upon all AIF instead of differentiating in accordance with size or type of AIF. Another example are additional own funds for which less stringent requirements could be imposed on UCITS-like AIF.

Types of AIF

Throughout the Consultation, ESMA draws distinctions and suggests differentiations based on types of AIF. EFAMA understands that ESMA is currently preparing proposals for definitions of types of AIF. These definitions will have far reaching consequences because they will determine the applicability of certain provisions to an AIF and/or AIFM. EFAMA gladly remains at ESMA's disposal and offers its expertise to help in the elaboration of such definitions.

For example, EFAMA proposes to define UCITS-like AIFs and to apply requirements of the AIFMD implementing measures in a proportionate manner to these funds (for example the transparency requirements or additional own fund requirements). A possible definition could be: "The AIF invests in assets which may be either eligible or equivalent according to the UCITS Directive and considers the risk spreading rules as well as the investment limits as provided in UCITS including the limits on leverage or such rules and limits which can be considered as equivalent to UCITS. This definition includes individual modifications according to national law."

In order to make full use of the industry expertise, EFAMA urges ESMA to organize open hearings, workshops and a consultation on any draft proposals of definitions of types of AIF.

Internally managed AIF

EFAMA understands that ESMA's proposed Draft Technical Advice has been prepared with externally managed AIF in mind. Unfortunately, parts of the advice are not suitable for internally managed AIF. EFAMA urges ESMA to review its advice and to mend it to accommodate internally-managed AIF.

Costs and benefits analysis

EFAMA welcomes the efforts already shown by ESMA in order to assess the costs and benefits of possible solutions for implementation of AIFMD. EFAMA encourages ESMA to take an even more rigorous stance in this respect and especially to disclose the reasons for preferring implementing options which incur more costs for AIFM or managed AIF than other possible approaches to Level 2 regulation, for example regarding the reporting obligations proposed in Box 109.

III. Article 3 exemptions

III.I. Identification of the portfolio of AIF under management by a particular AIFM and calculation of the value of assets under management

Box 1

Calculation of the total value of assets under management

1. In order to avail of the exemption set out in Article 3(2) the AIFM must carry out the following procedure:
 - Identify the AIF as defined in the AIFMD for which it is the AIFM where the legal form of the AIF permits internal management or the appointed external AIFM, in accordance with Article 5;
 - Calculate the value of the assets under management, including assets acquired through leverage, of each AIF to establish whether the assets under management of all AIFs exceed the threshold. UCITS for which the AIFM acts as the designated management company under the UCITS Directive are not included in the threshold calculation.
2. The total value of the assets under management should be calculated at least annually using the latest available net asset value calculation including assets acquired through leverage for each AIF. The latest available net asset value for each AIF must be produced within 12 months of the threshold calculation date. The AIFM must apply a consistent approach to the selection of the annual threshold calculation date and any change to the date chosen thereafter must be justified to the competent authority. In selecting the annual threshold calculation date the AIFM should take into account in particular, the net asset value calculation time and frequency of the AIFs under management.
3. Where an AIF invests in other AIFs managed by the same externally appointed AIFM this investment may be excluded from the calculation of the AIFM's assets under management subject to appropriate adjustments for leveraged exposure in accordance with the provisions of Box 2. Where one compartment within an internally or externally managed AIF invests in another compartment of that AIF this investment may be excluded from the calculation of the internal AIFM's assets under management subject to appropriate adjustments for leveraged exposure in accordance with the provisions of Box 2.
4. AIFMs should implement and apply procedures to monitor the value of total assets under management, including subscription and redemption activity or where applicable capital draw downs and distributions, on an on-going basis and should where necessary, taking into account proximity to threshold and anticipated subscription and redemption activity, recalculate the value of total assets under management.

5. The AIFM should assess situations where the value of total assets exceeds the threshold and, if it considers that the situation is not likely to be of a temporary nature, seek authorisation under Article 7 of the AIFMD.
- (a) Where the total value of assets under management exceeds the threshold the AIFM should notify the competent authority without delay stating whether the situation is considered to be of a temporary nature. This notification should, where relevant, include supporting information to justify the AIFM's view regarding the temporary nature of the situation.
- (b) The situation should not be considered to be of a temporary nature if it is likely to continue for a period in excess of three months.
- (c) At the end of the three month period the AIFM must recalculate the threshold to demonstrate that the total value of assets under management is below the threshold or demonstrate to the competent authority that the situation which resulted in the assets under management exceeding the threshold has been re-solved and an application for authorisation of the AIFM is not required.
6. Competent authorities should have the right to check that the AIFM is correctly calculating and monitoring the total assets under management, including occasions when assets under management temporarily exceed the threshold.

Box 1 Para. 3

EFAMA welcomes the suggested text of Box 1 Para. 3 allowing for an exclusion of investments by AIFs in other AIFs managed by the same AIFM, from the calculation of the total value of assets under management. EFAMA also welcomes the exclusion from the calculation of investments by one compartment within an AIF in another compartment of that AIF. EFAMA shares ESMA's reasoning that these investments should be excluded because on a look-through basis there is only one set of underlying assets.

With regard to leverage, EFAMA considers that it should not be necessary to look through to the underlying funds when calculating leverage in the investing AIF, provided this does not create any contingent liability at the level of the investing AIF, and EFAMA Members understand that the reference to Box 95 achieves this. However, it would ideally be confirmed explicitly in the text of Box 1.

Box 1 Para. 4

EFAMA understands that the obligation to monitor the value of total assets under management does not require a "full" valuation of these assets. For instance, where the value of the assets is not calculated on a frequent basis, AIFMs should be allowed to use estimations of the value of the assets in the portfolio instead of proceeding with a "full and proper" valuation and a calculation of the NAV.

Some EFAMA Members asked for an explicit confirmation of this understanding in the text of Box 1.

Box 1 Para. 5a

ESMA's draft technical advice provides that the AIFM should notify the competent authority without delay when the total value of assets under management exceeds the threshold to state whether the situation is considered to be of a temporary nature.

EFAMA considers that the requirement "without delay", which means immediately, will be difficult to respect in practice. One EFAMA Members suggested that the delay granted to notify the competent authority could be of one month where the net asset values (NAVs) of all the AIFs considered are calculated on a monthly basis and longer if the NAVs of the AIFs considered are calculated on a less frequent basis.

Furthermore, the requirement to notify the competent authority of any situation where the total value of assets exceeds the threshold, even if it is considered to be temporary, will result in a number of notifications which are unnecessary because the situation is of temporary nature only. EFAMA suggests that a notification should only be required if the situation is considered to be of permanent nature (or at least of a certain duration).

Box 1 Para. 5b

EFAMA Members suggested that the temporary nature of the situation should be assessed over a period longer than 3 months - depending on the frequency of the NAV calculation, i.e. a period of at least 6 months or even at least 12 months as some NAVs are calculated on a monthly basis or sometimes at an even lower frequency.

Q1: Does the requirement that net asset value prices for underlying AIFs must be produced within 12 months of the threshold calculation cause any difficulty for AIFMs, particularly those in start-up situations?

EFAMA Members do not foresee any difficulty with the requirement that the net asset value prices for underlying AIFs must be produced within 12 months of the threshold calculation.

Some EFAMA Members suggested flexibility in the start-up phase of AIFMs. The first financial period and accordingly also the threshold calculation could be extended to up to 18 months.

Q2: Do you think there is merit in ESMA specifying a single date, for example 31 December 2011 for the calculation of the threshold?

EFAMA does not believe that there is merit in ESMA specifying a single date for the calculation of the threshold.

The determination of the date for the calculation of the threshold should remain at the discretion of the AIFM which should be able to use the date most appropriate to them. This date will be determined by the reporting dates of the AIF the AIFM manages. For each AIF, the value of the assets will usually be the subject of an annual, external audit report and this will generally determine the preferred date of the AIFM with regard to this specific AIF. Furthermore, AIFM may manage several AIFs located in various jurisdictions with potentially different accounting periods. The AIFM should be able to decide which date is the most appropriate to calculate the threshold taking into account the features of the AIFs under management. Allowing the AIFMs this discretion will also allow them to choose the date that involves as few intermediary NAV calculations as possible, considering the closing dates of the AIF they manage.

Also, specifying a single date for the entire industry would lead to a significant concentration of workload at one point in the year, which is likely to lead to bottlenecks and increased operational costs.

Q3: Do you consider that using the annual net asset value calculation is an appropriate measure for all types of AIF, for example private equity or real estate? If you disagree with this proposal please specify an alternative approach.

EFAMA does not consider that using the annual net asset value calculation is an appropriate measure for all types of AIF.

The AIFMD will cover a very broad universe of AIF and a differentiated solution needs to be found to achieve a satisfactory result. The differences between AIFs covered, for example differences due to asset classes into which the funds are invested and differences due to the open-ended and closed-ended nature of the AIFs, should be reflected in the solution found. Taking these differences into account, different methods of calculating assets under management should be implemented.

EFAMA considers that currently, differentiated systems are applied as in each Member State the value of the assets follow the methodology set by relevant domestically recognized accountancy standards. EFAMA suggests that for the time being, this solution should be maintained and setting the appropriate measure for each AIF should be left to national regulators.

Q4: Can you provide examples of situations identified by the AIFM in monitoring the total value of assets under management which would and would not necessitate a re-calculation of the threshold?

EFAMA Members provided as general comment that it is important that monitoring should not be overly prescriptive, particularly for funds (such as closed ended funds) which do not calculate regular NAVs. An increase in AUM due to market exposure should not generally require a recalculation unless there is evidence that this is an established trend – since this is likely to be temporary in nature. On the other hand an increasing level of subscriptions over redemptions would clearly be indicative of a permanent increase in AUM.

To illustrate this, several EFAMA Members mentioned the situation of a closed end fund that invests in predetermined and defined assets, constituted for a pre-determined period with no redemption possibilities before the end date after which the investment is sold and paid out to the investors. For these funds this calculation should be made only at one point in time and could be used by the AIFM in calculating whether or not the assets under management are below or above the threshold. For these funds a re-calculation of the assets under management in view of the threshold seems not necessary. Examples of funds where this methodology could be applicable are certain real estate funds or funds investing in ships, where the assets are individually identified and disclosed in advance to investors.

However, for the avoidance of doubt, this does not exempt the AIFM to continue monitoring the "total assets under management" in respect of such other AIFs which it manages but only provides for the ability of the AIFM to set a fixed "assets under management value" in respect of certain closed-ended AIFs at a certain point in time.

Q5: Do you agree that AIFs which are exempt under Article 61 of the Directive should be included when calculating the threshold?

EFAMA Members do not agree that AIFs which are exempt under Article 61 of the AIFMD should be included when calculating the threshold. An AIFM managing "exempt AIFs" will not be subject to the AIFMD requirements. In respect of AIFM managing only "exempt AIFs", the "assets under management" test is not applicable. An AIFM managing only "exempt AIFs" could exceed the applicable thresholds under article 3 of the AIFMD and nonetheless remain exempted from the AIFMD requirements.

There is no explanation why "exempt AIFs" assets under management should be treated differently depending on whether the relevant AIFM is only managing "exempt AIFs" or managing a mix of "exempt AIFs" and "non-exempt AIFs".

III.II. Influences of leverage on the assets under management

Box 2

Calculation of Leverage

1. The AIFM must include assets acquired through leverage when calculating the total value of assets under management.
2. AIFMs shall calculate leverage using the Gross method of calculating the exposure of the AIF as set out in Box 95

Q6: Do you agree that AIFMs should include the gross exposure in the calculation of the value of assets under management when the gross exposure is higher than the AIF's net asset value?

EFAMA believes that the approach taken in the context of the calculation of the value of assets under management in view of the determination of the threshold should be consistent with the approach in Part VI of the Consultation Paper. The approach taken in Part VI allows for various options and thus provides the very welcome differentiation to accommodate the broad range of AIFs covered by the AIFMD.

EFAMA does not agree that AIFMs should include the gross exposure in the calculation of value of assets under management when the gross exposure is higher than the AIF's net asset value.

EFAMA calls for a consistent approach throughout the Level 2 measures of the AIFMD.

Q7: Do you consider that valid foreign exchange and interest rate hedging positions should be excluded when taking into account leverage for the purposes of calculating the total value of assets under management?

EFAMA calls for a consistent approach throughout the Level 2 measures of the AIFMD. Accordingly, EFAMA considers that valid foreign exchange and interest rate hedging positions should be excluded.

Q8: Do you consider that the proposed requirements for calculating the total value of assets under management set out in Boxes 1 and 2 are clear? Will this approach produce accurate results?

EFAMA considers that the proposed requirements for calculating the total value of assets under management are clear.

EFAMA Members suggested amendments to clarify further the text in Box 1:

Box 1 Para. 3

One EFAMA Member suggested that in the first line the words 'as manages the investing AIF' be inserted after the words 'the same externally appointed AIFM' for clarification.

With regard to leverage, it should not be necessary to look through to the underlying funds when calculating leverage in the investing AIF provided this does not create any contingent liability at the level of the investing AIF, and EFAMA Members understand that the reference to Box 95 achieves this. However, it would ideally be confirmed explicitly in the text of Box 1.

Box 1 Para. 5

ESMA's draft technical advice provides that the AIFM should notify the competent authority without delay when the total value of assets under management exceeds the threshold to state whether the situation is considered to be of a temporary nature.

EFAMA considers that the requirement "without delay", which means immediately, will be difficult to respect in practice. One EFAMA Members suggested that the delay granted to notify the competent authority could be of one month where the net asset values (NAVs) of all the AIFs considered are calculated on a monthly basis and longer if the NAVs of the AIFs considered are calculated on a less frequent basis.

Furthermore, the requirement to notify the competent authority of any situation where the total value of assets exceeds the threshold will result in a number of notifications which are unnecessary because the situation is temporary. EFAMA suggests that a notification should only be required if the situation is considered to be of permanent nature (or at least of a certain duration).

III.III. Content of the obligation to register with national competent authorities and suitable mechanisms for gathering information

Box 3**Information to be provided as part of registration**

In relation to the information provided to competent authorities as part of the registration process, the following is proposed:

1. Article 3(3)(b): The total value of assets under management calculated in accordance with the procedure set out in Boxes 1 and 2 should be included with the identity of the AIFs under management.
2. Article 3(3)(c): In order to provide updated information on the investment strategies of the AIFs,

the AIFM may provide the offering document or a relevant extract from the offering document or a general description of the investment strategy. The description of the investment strategy should at least include the following information:

- the main categories of asset in which the AIF will invest;
- any industrial, geographic or other market sectors or specific classes of asset which are the focus of the investment strategy; and
- a description of the AIF's borrowing or leverage policy.

3. Article 3(3)(d): Information collected in accordance with this article should be subject to the provisions of Article 50 of the AIFMD in relation to exchange of information between authorities.
4. The updated information referred to in this Article should be provided on a quarterly basis.
5. Competent authorities may require the AIFM to provide the information set out in paragraph 1 and 2 on a more frequent basis.

Box 3 Para. 2

EFAMA considers that the requirements for information to be provided to competent authorities as part of the registration process should be harmonised at EU Level. This is necessary to ensure an equal treatment of AIFMs wherever they are domiciled. Pan-European harmonisation is also required to avoid that AIFMs operating cross-border might face different requirements from one country to another which is not easy to manage.

In order to achieve a harmonisation at European level, the information required for the description of the investment policy should be determined in an exhaustive manner in Box 3. EFAMA therefore suggests deleting the words "at least" from Box 3 Para. 2.

Box 3 Para. 4

EFAMA considers that the provision of updated information on a quarterly basis is too frequent and will be too burdensome for authorities and AIFM. EFAMA suggests that the provision of updated information should be made annually.

Furthermore, providing the information required in Box 3 in addition to the information required in Box 109 is likely to lead to duplications and poses an undue burden on both the regulators who will need to process the information received and on the AIFM providing the information.

Box 3 Para. 5

EFAMA considers that the requirements for frequency of information to be provided to competent authorities should be harmonised at EU Level. Again, this is necessary to ensure an equal treatment of AIFMs wherever they are domiciled and also because otherwise pan-European AIFMs might face different requirements from one country to another and it would not be easy to manage. Therefore, competent authorities should not have the possibility to request information on a more frequent basis than determined in Box 3 Para. 4. And Box 3 Para. 5 should be deleted.

III.IV. Opt-in procedure**Box 4****Procedures**

1. AIFMs that benefit from the exemption set out in Article 3 and that elect to seek authorisation under the AIFMD should contact their home competent authority and follow the procedure outlined in Articles 7 and 8.
2. AIFMs which were previously registered with a competent authority in accordance with the requirements of Article 3(2) and which elect for authorisation should submit all documents set out in Article 7, which have not been previously been submitted for registration purposes provided that there has been no material change to the information previously submitted. This is without prejudice to the position of UCITS management companies, to which the provisions of Article 7(4) apply as set out above.

Box 4 Para. 1

A large majority of EFAMA Members consider that AIFMs which are opting into the Directive should be subject to the same procedure as AIFMs falling under the scope of the Directive.

One EFAMA Member would prefer that the procedure of opting-in AIFM should allow some flexibility and should be proportionate to the size of the AIFM.

Box 4 Para. 2

EFAMA agrees that there should only be the requirement to submit information not previously provided for registration purposes and, in case there has been a material change to that information, to update it.

Box 5**AIFMs falling below the threshold**

1. An AIFM which is authorised in accordance with the Directive as a result of being above the threshold set out in Article 3(2) of the AIFMD who subsequently falls below this threshold should:
 - consider notifying the competent authority that it intends to remain authorised under the AIFMD in accordance with the opt-in provisions; or
 - demonstrate to the competent authority that it will remain below the threshold and seek revocation of its authorisation.

Box 5

No comment.

IV. General Operating Conditions

IV.I. Possible Implementing Measures on Additional Own Funds and Professional Indemnity Insurance

General Comments

Internally Managed AIF

EFAMA understands that ESMA's proposed Draft Technical Advice regarding possible implementing measures on Additional Own Funds and Professional Indemnity Insurance has been prepared for externally managed AIFs.

Unfortunately, for internally managed AIF, the proposed Draft Technical Advice is not appropriate and leaves a number of practical questions open:

- First, it is unclear how the additional own funds should be raised. EFAMA understands that these funds are taken out of the investments by the investors.
- It is also unclear whether these additional own funds will be considered as part of the AIF's assets to be invested (subject to Article 9 para. 8 of the AIFMD) or whether they need to be segregated from the other assets of the AIF. In the latter case, the investors of the internally managed AIF will only receive the performance of their subscribed amount net of the own-funds' performance which will be withheld.
- Another example is the case of closed-ended self-managed AIFs whose assets are fully invested in accordance with their investment policy. It is unclear how such vehicles should raise their additional own funds or solve cases of adjustments during the life of the AIF.

EFAMA understands that part of these issues arise from the Level 1 text of the AIFMD and cannot be solved by Implementing Measures. A possible solution would for example be to amend Article 9 para. 6 of the AIFMD to allow internally managed AIFs not to provide any additional amount of own funds if they benefit from a guarantee covering 100% of the additional amount of own funds.

However, as far as possible, EFAMA urges ESMA to seek a solution to the open questions through the implementing measures.

Introduction of a Cap for additional own funds

ESMA's current advice does not provide for a cap on the additional own funds. EFAMA Members would strongly suggest to include a cap for additional own funds into the requirements reflecting the

cap of Euro 10 Million already provided for in the directive regarding own funds. This would be in line with the intention of the Level 1 text not to pose an undue infinite burden on AIFM.

Combination of additional own funds and PII

EFAMA would welcome if ESMA could explicitly specify that an AIFM may not only chose between additional own funds and professional indemnity insurance but may also use a combination of both.

Proportionality Principle

EFAMA considers that the current proposal of implementing measures for additional own funds or professional indemnity insurance pose important requirements on AIFM. Some EFAMA Members consider that in particular for "UCITS-like" funds, these provisions bear a significant risk of over-capitalization in relation to potential liability risks resulting from their operational activities. Consequently, it might be useful, if ESMA would distinguish between "UCITS-like" funds and other AIF in this regard.

A possible definition of UCITS-like funds could be "The AIF invests in assets which may be either eligible or equivalent according to the UCITS Directive and considers the risk spreading rules as well as the investment limits as provided in UCITS including the limits on leverage or such rules and limits which can be considered as equivalent to UCITS. This definition includes individual modifications according to national law."

1. Description of potential risks

Box 6

Potential risks arising from professional negligence to be covered by additional own funds or professional indemnity insurance

1. The AIFM must be able to cover the potential liabilities arising from professional negligence.
2. The potential liability risks to be covered are the risk of losses arising from the activities of the AIFM for which the AIFM has legal responsibility. Those are particularly
 - (a) Risks in relation to fraud:
Losses due to dishonest, fraudulent or malicious acts by relevant persons.
 - (b) Risks in relation to investors, products & business practices:
Losses arising from a negligent failure to meet a professional obligation to specific investors and clients

Those risks particularly include

- i. negligent loss of documents evidencing title of assets of the AIF
- ii. misrepresentations and misleading statements made to the AIF or its investors by the AIFM or relevant persons
- iii. negligent acts, errors or omissions by the AIFM resulting in a breach of:
 - a. obligations according to law and regulatory framework
 - b. duty of skill and care to the AIF when carrying out its professional activities
 - c. obligations of confidentiality
 - d. AIF rules or instruments of incorporation
 - e. terms of its appointment by the AIF
- iv. improper valuation of assets and calculation of unit/share prices

(c) Risks in relation to business disruption, system failures, process management:

Losses arising from negligent failure resulting in or not adequate prohibiting the disruption of business or system failures, from failed transaction processing or process management

Box 6

Terminology

The terminology in Box 6 is not in line with terms used in the insurance industry and EFAMA suggests aligning it more closely to the terminology of the insurance industry. For example an insurance coverage is normally related to "losses" and not to "risk" and the wording in para. 2 b should be modified accordingly.

Furthermore, EFAMA would appreciate if ESMA could include the definitions of page 29 of the Consultation into the text of Box 6 in order to avoid future diverging interpretation and implementation.

Combination of additional own funds and PII

EFAMA would welcome if ESMA could explicitly specify that AIFM may use a combination of additional own funds and professional indemnity insurance.

Delegation Context

EFAMA understands that ESMA, through the provisions in Box 6 and the definitions on page 29 seeks to provide coverage for potential risks of all "relevant persons", including persons who are providing services under a delegation arrangement.

First, EFAMA would appreciate if the definitions on page 29 could be included into the text of Box 6 in order to ensure that they become part of the Level 2 provisions.

Furthermore, EFAMA considers that the coverage of such losses through additional own funds or a professional indemnity insurance constitutes a very strict and far going measure. An indemnity insurance that covers the risks of relevant persons is very difficult to implement. The AIFM normally is not aware about all the risks of the delegate as the delegate is not legally obliged to inform the AIFM about all its risks.

Some EFAMA Members believe that the requirements are too far going. They consider that the AIFM should only be required to have appropriate cover where the loss arises due to negligence of the AIFM in appointing and supervising the delegate.

This being said, EFAMA expects from the delegate to have its own indemnity insurance. EFAMA suggests that Box 6 should be amended and risks of the delegate should be excluded if the delegate holds an own sufficient indemnity insurance. A double coverage of the risks through an insurance at the level of the AIFM and the delegate should be avoided.

Box 6 para. 2a – Risks related to fraud

EFAMA is surprised by the proposed implementing measures providing that the potential liability risks to be covered should include the risks in relation to fraud. Risks in relation to fraud are not mentioned in Article 9 AIFMD. Indemnity insurances normally only cover negligent behaviour and not fraud, which are acts of criminal offence committed deliberately and not negligently. Entitlements of third persons that refer to fraud are not part of an indemnity insurance. The scope of potential liabilities of an AIFM should therefore be restricted to risks arising from negligence, not risks arising from deliberate misbehaviour of employees of the AIFM or third parties. EFAMA therefore suggests that para. 2a be deleted.

Box 6 para. 2c – Risks related to mechanical failures

Para. 2c of Box 6 concerns risks related to mechanical failures. The current draft technical advice suggests that the additional own funds or the professional indemnity insurance should also cover risks related to such mechanical failures. Current practice of the insurance industry however is, that losses resulting from mechanical failures are excluded from insurance coverage, unless the loss is a result of an intervention or manipulation (staff of) the AIFM. Box 6 para. 2c should be modified accordingly.

Q9: The risk to be covered according to paragraph 2 (b)(iv) of Box 6 (the improper valuation) would also include valuation performed by an appointed external valuer. Do you consider this as feasible and practicable?

EFAMA considers ESMA's proposal as very far going that the AIFM should be liable for valuations performed by an appointed external valuer, according to the general principle that the AIFM is

responsible for the valuation. EFAMA Members consider it as feasible, but as very far going rule. It is difficult to see how the risk referred to (i.e., the risk that an appointed external valuer improperly values assets or calculates units / share prices) could be covered in the manner contemplated by the draft rules - either by additional own funds or insurance.

Again, EFAMA would suggest that due allowance should be made for adequate capital backing or insurance coverage provided by the external valuer. There is no necessity to require a double layer of safeguards for the same liability risk.

2. Methods to calculate amounts of additional own funds or coverage of professional indemnity insurance (PII) and the determination of adjustments

Box 7

Qualitative Requirements (based on Annex X Directive Part 3 2006/48/EC)

1. The AIFM should implement effective internal operational risk management policies and procedures in order to identify, measure, manage and monitor appropriately operational risk including liability risks to which the AIFM is or could be reasonably exposed. The operational risk management activities shall be performed independently. For this purpose the AIFM should, appropriate to the size and organisation of the AIFM and the nature, scale and complexity of its business, establish and maintain a separate operational risk management function in accordance with the requirements set out in Box 30.
2. Any operational failures and loss experience must be recorded and an historical loss database must be set up by the AIFM.
3. Within the risk management framework the AIFM should make use of its historical internal loss data and where appropriate of external data, scenario analysis and factors reflecting the business environment and internal control systems.
4. There must be regular internal reporting of operational risk exposures and loss experience.
5. The AIFM must have procedures for taking appropriate corrective action.
6. The AIFM's operational risk management policies and procedures must be well documented. The AIFM must have routines in place for ensuring compliance and policies for the treatment of non-compliance.
7. The operational risk management policies and procedures and measurement systems shall be subject to regular reviews.
8. The AIFM must maintain adequate financial resources. On the basis of the assessed risk profile, the

AIFM has to ensure that liability risk arising from professional negligence are covered by own funds or professional indemnity insurance at all times.

Box 7

Some EFAMA Members appreciated the suggestions presented in Box 7 and especially, support the notion of establishing a historical loss database at the AIFM level which could be helpful for demonstrating that the AIFMD capital requirements do not match with a company's individual potential for liability risk.

Other EFAMA Members do not support the proposals in Box 7, and suggest that if any reference is included to operational risk, this should be limited to an obligation to implement risk management facilities which reflect the size and internal organisation of the AIFM, and the nature, scale and complexity of its activities.

EFAMA would like to point out that the AIFMD does not include a specific obligation for AIFMs to measure, manage or mitigate operational risk (the concept of risk management applies to all risks and does not specify individual risk types which must be managed).

EFAMA would welcome a clarification that Level 2 does not bring requirements going beyond the requirements in Level 1 of the AIFMD. In this regard, EFAMA would welcome a clarification that the requirement to "maintain a separate operational risk management function" refers exclusively to the provisions set out in Box 30 and does not suggest the necessity to establish a separate function specifically for the purpose of managing risks in terms of operational liability.

Box 8

Quantitative Requirements

1. Option 1:

The additional own funds requirement for liability risk is equal to 0.01% of the value of the portfolios of AIF managed by the AIFM.

Option 2: The additional own funds requirement for liability risk is equal to 0.0015% of the value of the portfolios of AIF managed by the AIFM plus 2% of the relevant income.

2. Relevant income is calculated considering the following requirements:

(a) Relevant income is the sum of all income received in relation to the collective portfolio management activities of the AIFM subtracting the sum of commission and fees payable in relation to collective portfolio management activities calculated as average over three years;

(b) The three-year average is calculated on the basis of the last three twelve-monthly

observations at the end of the financial year. When audited figures are not available, paragraph 1 option 1 should be used;

(c) If for any given observation, the sum of the income is negative or equal to zero, this figure shall not be taken into account in the calculation of the three-year average; however, if the sum of the last three years is negative or equal to zero, paragraph 1 option 1 should be used;

(d) The relevant income is calculated as the sum of positive figures divided by the number of positive figures;

3. The own funds requirement is recalculated and adjusted if necessary at the end of each financial year.

4. Option 1

The competent authority of the home Member State of the AIFM may authorize the AIFM to lower the percentage to 0.008%, provided that the AIFM can demonstrate -based on its historical loss data according to Box 2 and a minimum historical observation period of five years- that liability risk according to Box 1 is adequately captured. Conversely, the competent authority may rise the additional own funds requirements if they are not sufficient to capture liability risk arising from professional negligence.

Option 2

The competent authority of the home Member State of the AIFM may authorize the AIFM to lower the percentage in relation to relevant income to 1%, provided that the AIFM can demonstrate -based on its historical loss data according to Box 2 and a minimum historical observation period of five years- that liability risk according to Box 1 is adequately captured. Conversely, the competent authority may rise the additional own funds requirements if they are not sufficient to capture liability risk arising from professional negligence.

Box 8

Introduction of a Cap for additional own funds

ESMA's current advice does not provide for a cap on the additional own funds. EFAMA pleads in favor of a cap for additional own funds into the proposed requirements. This would reflect the cap already included in the directive regarding the own funds and help to avoid overly burdensome requirements for AIFM.

Preference for Option 1

Of the 2 options presented in Box 8, a majority of EFAMA Members show a preference for Option 1. EFAMA understands and welcomes the logic of determining the additional own funds requirement

for liability risk in relation to the value of the portfolios of AIF managed by the AIFM. Furthermore, Option 1 has the clear advantage of simplicity.

Option 2 on the other hand is based on a combination of assets under management and relevant income. However, there is no logical link between the liability risk and the income of an AIFM. Option 2 also seems more complicated, leaves a very wide room for interpretation and brings the risk of an unlevel application by different competent authorities. "Relevant income" will be difficult to interpret and to determine in practice. Furthermore, the "relevant income" should only refer to the income derived from the activity as AIFM. In practice, AIFM very often also act as UCITS management and provide services as MiFID firms. To determine their relevant income attributable to the activity as AIFM will be very difficult and cumbersome in practice. Therefore, Option 2 seems very cumbersome.

Lowering quantitative requirements

For both options, EFAMA considers that ESMA in its advice should significantly lower the quantitative requirements for the additional own funds. Some EFAMA Members have calculated simulations of additional own funds based on option 1 and on option 2. For both cases, the additional funds required seemed very high compared to historical loss data. These EFAMA Members are also submitting replies directly to ESMA and therefore, EFAMA refrains from copying the figures. EFAMA would welcome if ESMA lowered the quantitative requirements for the additional own funds.

One EFAMA Member considers that it is not appropriate to grant the power to competent authorities of the home Member State to reduce the additional own funds requirements. This EFAMA Member considers that such power should only exist in a harmonized pan-European manner to be exercised by ESMA to avoid regulatory dumping. However, the majority of EFAMA Members consider that competent authorities of home Member States should have this power.

Q10: Please note that the term 'relevant income' used in Box 8 includes performance fees received. Do you consider this as feasible and practicable?

EFAMA does not consider that the term "relevant income" used in Box 8 should include performance fees received. There is no direct connection between increasing performance fees and increasing risks. Including performance fees received as part of relevant income may mean that the own funds maintained by AIFM will change materially from year to year (depending on whether performance benchmarks are exceeded) even though the risk in the funds may have remained constant.

Q11: Please note that the term 'relevant income' used in Box 8 does not include the sum of commission and fees payable in relation to collective portfolio management activities. Do you consider this as practicable or should additional own funds requirements rather be based on income including such commissions and fees ('gross income')?

EFAMA considers that the term “relevant income” should not include the sums of commission and fees payable in relation to collective portfolio management activities. The requirements of the AIFMD and its implementing measures should only require an AIFM to hold additional own funds against any risks which arise from business associated with its activity as AIFM. Capital requirements regarding other activities should be dealt with outside of the AIFMD.

Q12: Please provide empirical evidence for liability risk figures, consequent own funds calculation and the implication of the two suggested methods for your business. When suggesting different number, please provide evidence for this suggestion.

No comment.

Q13: Do you see a practical need to allow for the ‘Advanced Measurement Approach’ outlined in Directive 2006/48/EC as an optional framework for the AIFM?

EFAMA does not necessarily see any practical need to allow for the “Advanced Measurement Approach” as an optional framework. Within the AIFMD, there is no specific obligation placed on an AIFM to manage operational risk. It therefore seems unnecessary to include reference to the standards required of firms (banks) which have a legislative obligation to measure, manage and mitigate operational risk. The standards of operational risk management which are adopted by the AIFM should reflect the risk to which it is exposed, and AIFMs should be provided with sufficient flexibility to implement a risk management solution which is appropriate to the nature, scale and complexity of the AIFM.

Q14: Paragraph 4 of Box 8 provides that the competent authority of the AIFM may authorise the AIFM to lower the percentage if the AIFM can demonstrate that the lower amount adequately covers the liabilities based on historical loss data of five years. Do you consider this five-year period as appropriate or should the period be extended?

One EFAMA Member considers that it is not appropriate to grant the power to competent authorities of the home Member State to reduce the additional own funds requirements. This EFAMA Member considers that such power should only exist in a harmonized pan-European manner to be exercised by ESMA to avoid regulatory dumping.

However, the majority of EFAMA Members consider that competent authorities of home Member States should have this power. They welcome that the competent authority may lower the requirements for the additional own funds. This power should be given to the competent authority independently whether ESMA presents Option 1 or Option 2 to the Commission.

Some EFAMA Members suggest that, in line with article 9 (6) of Level 1, a reduction of 50% of the additional funds should be possible if the AIFM benefits from a guarantee of the same amount given by a credit institution or an insurance undertaking.

EFAMA furthermore believes that the minimum historical observation period of 5 years is too long and should be reduced, for example to 3 years. Requiring a minimum observation period of 5 years would prevent AIFM with a shorter track record for a very long time from being able to apply for reduction of capital requirements.

Further, EFAMA would welcome if ESMA could include guidelines on the use of historical data in case of AIFM restructurings (for example in case of mergers or transformation). In cases of mergers, the historical loss data collected prior to the merger should in principle still be used for the purpose of assessing the individual potential for liability risks.

Box 9

Professional Indemnity Insurance

1. As an alternative to the requirements in Box 8 paragraph 1 regarding additional own funds, the AIFM may take out and maintain at all times professional indemnity insurance complying with the following requirements:
 - (a) The insurance policy must have an initial term of no less than one year;
 - (b) The cover provided by the policy is wide enough to include the liabilities of the AIFM and relevant persons;
 - (c) There are no exclusions regarding liability risks listed in Box 1;
 - (d) Any defined excess is covered by own funds;
 - (e) The insurance is taken out from an insurance undertaking authorized to transact professional indemnity insurance, which is subject to prudential regulation and ongoing supervision and has sufficient financial strength with regard to the claims paying ability. In case of third country insurance undertakings, the AIFM has to demonstrate to the competent authority, that those requirements are fulfilled;
 - (f) The insurance is provided by a third party entity. In the case of insurance through affiliates, the exposure has to be laid off to an independent third party entity, for example through re-insurance, that meets the eligibility criteria;
2. The coverage of the insurance per claim must be adequate for the individual AIFM liability risk. The minimum coverage of the insurance for each claim must at least equal the higher of the following amounts:
 - (a) 0.75 % of the amount by which the value of the portfolios of the AIFM exceeds €250 million, up to a maximum of €20 million;
 - (b) €2 million.
3. The coverage of the insurance for claims in aggregate per year must be adequate for the

individual AIFM liability risk. The minimum coverage of the insurance for all claims in aggregate per year must at least equal the maximum of the following amounts:

- (a) 1 % of the amount by which the value of the portfolios of the AIFM exceeds €250 million up to a maximum of €25 million;
- (b) €2.5 million;
- (c) the amount calculated according to Box 8.

4. The AIFM should review the policy and its compliance with the requirements at least once a year and in the event of any change which affects compliance of the policy with the requirements.

General Remarks to Box 9

Box 9 Para. 1c

In practice, insurance policies do usually not cover all risks listed in Box 6. Insurance policies usually define the losses and risks to be covered and the maximum compensation they can offer for each defined risk. Therefore, insurance policies usually set out exclusions and limits. Furthermore, in practice, it is not unusual that several insurances are concluded each covering only parts of the risks. Box 9 Para. 1c should be modified to take this into account.

Box 9 Para. 1d

The wording is unclear.

Box 9 Para. 1e

EFAMA suggests that the first sentence should stop after the words "ongoing supervision". Where an insurance company is licensed and under prudential supervision it should not be the task/responsibility of the AIFM to assess the ability of the insurance company to pay claims. As the insurance company is regulated there should be the assumption that it is able to pay claims and in practice the AIFM will not be able to verify if this is the case.

Box 9 Para. 1f

EFAMA sees no need to provide for a different solution regarding insurance coverage from "affiliated entities". If insurance coverage is obtained from a separate legal entity (regulated insurance company) within a financial group, this "affiliated" insurance company has to fulfill all (prudential) rules that every "independent" insurance company also has to fulfill. There should therefore be no restrictions with regard to "affiliated" insurance companies.

Box 9 Para. 4

EFAMA considers that the frequency of the review should be harmonised at a European level. The review should be conducted once a year and thus “at least” should be deleted from Box 9 Para. 4.

Further it should be reviewed in the event of any “material” change and not in the event of every change.

Q15: Would you consider it more appropriate to set lower minimum amounts for single claims, but higher amounts for claims in aggregate per year for AIFs with many investors (e.g. requiring paragraph 2 of Box 9 only for AIFs with fewer than 30 investors)? Where there are more than 30 investors, the amount in paragraph 3 (b) would be increased e.g. to €3.5 m, while for more than 100 investors, the amount in paragraph 3 (b) would be increased e.g. to €4 m.

EFAMA does not see the reason why the number of investors should have any influence on the amount to be covered by the insurance. If a loss occurs, the amount of the loss is independent of the number of investors in the fund. Furthermore, one loss leads to one event/claim in the insurance policy independently of the number of investors in the fund.

IV.II. Possible Implementing Measures on General Principles

Box 10

Duty to act in the best interests of the AIF or the investors of the AIF and the integrity of the market

1. AIFM should apply appropriate policies and procedures for preventing malpractices that might reasonably be expected to affect the stability and integrity of the market.
2. AIFM should act in such a way as to prevent undue costs being charged to the AIF and its investors.

Box 10 Para. 1

EFAMA agrees with this adaptation of the UCITS standards as proposed by ESMA. However, EFAMA would like to point out that while UCITS Management Companies and AIFM are subject to these obligations, other market players are not. EFAMA invites the Commission to include these requirements into a horizontal legislation to establish a level-playing-field.

Box 11**Due Diligence requirements**

1. AIFM should ensure a high level of diligence in the selection and ongoing monitoring of investments, in the best interests of the AIF, its investors and the integrity of the market.
2. AIFM should ensure that they have adequate knowledge and understanding of the assets in which the AIF are invested.
3. AIFM should establish written policies and procedures on due diligence and implement effective arrangements for ensuring that investment decisions on behalf of the AIF are carried out in compliance with the objectives, investment strategy and, where applicable, risk limits of the AIF. The due diligence processes and procedures should be regularly reviewed and updated.
4. Where applicable to the type of asset, the AIFM should in addition to the requirements in paragraph 1 to 3
 - (a) set out and update a business plan consistent with the duration of the AIF and market conditions;
 - (b) seek and select possible transactions consistent with the plan referred to under point (a);
 - (c) assess the selected transactions in consideration of opportunities, if any, and overall related risks, all relevant legal, fiscal, financial or other value affecting factors, human and material resources as well as strategies, including exit strategies;
 - (d) perform any due diligence activities related to the transactions prior to arranging execution;
 - (e) monitor the management performance of the AIF with respect to the plan referred to under point (a).
5. AIFM should retain records on the activities performed pursuant to paragraph 4 for a period of at least five years.

Box 11 Para. 4 and 5

The explanatory text regarding Box 11 Para. 4 and 5 explains that the additional due diligence requirements with which AIFMs must comply only apply when AIFM invest the AIFs assets in specific types of assets such as real estate or partnership interests and in any case, does not concern investments in financial instruments.

Para. 15 of the explanatory text also mentions that the evidence of the significant investment opportunities shall be maintained with regard to specific assets and for a five year period.

EFAMA suggests that only evidence regarding significant investments, not investment opportunities should be kept. Furthermore, it should be specified that this requirement only applies as of the entry

into force of the implementing measures of the AIFMD as some contracts currently commit fund managers to erase the recorded data on potential investments.

EFAMA sees a strong need to include explicit clarifications in this regard into the text of the Box 11 both under Para. 4 and under Para. 5. Should such clarification not be explicitly included, there is a very strong risk of diverging interpretation by the different competent authorities.

Q16: Paragraphs 4 and 5 of Box 11 set out additional due diligence requirements with which AIFMs must comply when investing on behalf of AIFs in specific types of asset e.g. real estate or partnership interests. In this context, paragraph 4(a) requires AIFMs to set out a 'business plan'. Do you agree with the term 'business plan' or should another term be used?

EFAMA Members agree that the term "business plan" was rather confusing and too limited to cover all cases. They suggested the term "investment proposal".

Box 12

Reporting Obligations in respect of execution of subscription and redemption orders

1. Where AIFM have carried out a subscription or, where relevant, redemption order from an investor, they must promptly provide the investor, in a durable medium, with the essential information concerning the execution of that order.
2. AIFM shall supply the investor, upon request, with information about the status of the order.

Box 12

EFAMA understands that where the subscription or redemption orders are processed by a third party (for example a third party distributor) and not by the AIFM, the reporting obligations shall lay with the third party and not with the AIFM. In this case it should not be the AIFM's obligation to provide the investor with the essential information concerning the execution of that order and, upon request, with information about the status of the order. It should rather be the respective third party's obligation to comply with these reporting requirements.

Box 13

Selection and appointment of counterparties and prime brokers

1. When selecting and appointing counterparties and prime brokers AIFM should exercise due skill, care and diligence prior entering into an agreement and on an ongoing basis by considering the full range and quality of their services. AIFM should ensure that counterparties and prime brokers are chosen which are subject to ongoing supervision by a public authority, are of financial soundness and have the necessary organisational structure for the services provided by them.

2. For the purpose of paragraph 1 AIFM should maintain a list of the appointed prime brokers approved by senior management. Only in exceptional cases and subject to approval by senior management the AIFM may appoint prime brokers not included in the list. The AIFM should demonstrate the reasons for such a choice and the diligence that it exercised in selecting and monitoring these prime brokers.
3. For the purpose of this Box, counterparty means a counterparty of an AIFM in an OTC transaction, in a securities lending or in a repurchase agreement.

Box 13 Para. 1

EFAMA considers the requirements in Box 13 Para. 1 too far going and suggests that the text be modified:

The range of services to be considered in the framework of selection and appointment of counterparties should not be the full range of services but instead be limited to the services the AIFM would like to mandate the counterparty for. For example, if a broker is only used for brokerage services, any research services it might also propose should not need to be considered.

EFAMA also considers that it should be sufficient that counterparties and prime brokers are subject to authorisation and supervision in their jurisdiction. The requirement of ongoing supervision in any jurisdiction in which the counterparty is active would be too burdensome and restrictive.

Box 13 Para. 2

EFAMA suggests modifying Box 13 Para. 2 by including the words “be able to” before “demonstrate the reasons for such a choice”.

Box 13 Para. 3

EFAMA suggests modifying Box 13 Para. 3 to “counterparty of an AIFM or AIF” as in practice such contracts are made in the name of the AIF or the AIFM.

Box 14

Execution of decisions to deal on behalf of the managed AIF

1. AIFM should act in the best interest of the AIF or the investors of the AIF they manage when executing decisions to deal on behalf of the managed AIF in the context of the management of their portfolio.
2. Whenever AIFM buy or sell financial instruments or other assets and for the purpose of

paragraph 1, AIFM should take all reasonable steps to obtain the best possible result for the AIF or the investors of the AIF, taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order. The relative importance of such factors shall be determined by reference to the following criteria:

- (a) the objectives, investment policy and risks specific to the AIF, as indicated in the fund rules or article of association, prospectus or offering documents of the AIF;
 - (b) the characteristic of the order;
 - (c) the characteristics of the financial instruments or other assets that are the subject of that order;
 - (d) the characteristics of the execution venues to which that order can be directed.
3. AIFM should establish and implement effective arrangements for complying with the obligation referred to in paragraph 2. In particular, AIFM should establish and implement a written policy to allow them to obtain, for AIF orders, the best possible result in accordance with paragraph 2.
 4. AIFM shall monitor on a regular basis the effectiveness of their arrangements and policy for the execution of orders in order to identify and, where appropriate, correct any deficiencies.
- In addition, AIFM should review the execution policy on an annual basis. A review should also be carried out whenever a material change occurs that affects the AIFM's ability to continue to obtain the best possible result for the managed AIF.
5. AIFM should be able to demonstrate that they have executed orders on behalf of the AIF in accordance with the AIFM's execution policy.
 6. Whenever there is no choice of different execution venues, AIFM should not be obliged to comply with paragraph 2 to 5. AIFM should be able to demonstrate that there is no choice of different execution venues.

Box 14

EFAMA welcomes the clarification in Explanatory Text 21 that Box 14 paragraph 1 shall apply to all AIFs while paragraphs 2-5 only apply to those types of AIFs which acquire or sell financial instruments or other assets for which best execution is relevant. However, EFAMA strongly urges ESMA to include this clarification directly into the text of Box 14 to avoid diverging or contradictory future interpretations.

EFAMA understands that best execution requirements need and can be applicable to transactions in financial instruments (as defined in annex 1 of MiFID). However, ESMA suggests in Box 14 to make these requirements also applicable to investments in other types of assets. EFAMA believes that this is not appropriate as the further requirements are tailored to transactions in financial instruments and not to other asset types like e.g. real estate, private equity, ships etc. EFAMA therefore suggests that the words "or other assets that are" after "financial instruments" should be deleted.

Furthermore, EFAMA would welcome a clarification for cases of delegation of portfolio management. In case of delegation of portfolio management by the AIFM, the obligations under Box 14 should be fulfilled by the portfolio manager. In this case, and notwithstanding the obligations under Box 63-72, the AIFM should not be required to fulfill the obligations under Box 14.

Box 15

Placing orders to deal on behalf of AIFs with other entities for execution

1. Whenever AIFM buy or sell financial instruments or other assets, they should act in the best interests of the AIF they manage when placing orders to deal on behalf of the managed AIF with other entities for execution, in the context of the management of their portfolio.
2. AIFM should take all reasonable steps to obtain the best possible result for the AIF or the investors of the AIF taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order. The relative importance of such factors should be determined by reference to B. 5 paragraph 2.

For those purposes, AIFM should establish and implement a policy to enable them to comply with the obligation referred to in the first subparagraph. The policy should identify, in respect of each class of instruments, the entities with which the orders may be placed. AIFM should only enter into arrangements for execution where such arrangements are consistent with obligations laid down in this box. AIFM should make available to investors appropriate information on the policy established in accordance with this box and on any material changes to this policy.

3. AIFM should monitor on a regular basis the effectiveness of the policy established in accordance with paragraph 2 and, in particular, the execution qualities of the entities identified in that policy and, where appropriate, correct any deficiencies.

In addition, AIFM should review the policy on an annual basis. Such a review shall also be carried out whenever a material change occurs that affects the AIFM's ability to continue to obtain the best possible result for the managed AIF.

4. AIFM should be able to demonstrate that they have placed orders on behalf of the AIF in accordance with the policy established in accordance with paragraph 2.
5. Whenever there is no choice of different execution venues, AIFM should not be obliged to comply with paragraph 2 to 4. AIFM should be able to demonstrate that there is no choice of different execution venues.

Box 15

EFAMA welcomes the clarification in Explanatory Text 24 that Box 15 paragraph 1 shall apply to all AIF, while paragraphs 2-5 only apply to those types of AIF which acquire or sell financial instruments

or other assets for which best execution is relevant. However, EFAMA strongly urges ESMA to include this clarification directly into the text of Box 15 to avoid diverging or contradictory future interpretations.

EFAMA understands that best execution requirements need and can be applicable to transactions in financial instruments (as defined in annex 1 of MiFID). However, ESMA suggests in Box 15 to make these requirements also applicable to investments in other types of assets. EFAMA believes that this is not appropriate as the further requirements are tailored to transactions in financial instruments and not to other asset types like e.g. real estate, private equity, ships etc. EFAMA therefore suggests that the words "or other assets" after "financial instruments" should be deleted.

Furthermore, EFAMA would welcome a clarification for cases of delegation of portfolio management. In case of delegation of portfolio management by the AIFM, the obligations under Box 15 should be fulfilled by the portfolio manager. In this case, and notwithstanding the obligations under Box 63-72, the AIFM should not be required to fulfill the obligations under Box 15.

Box 16

Handling of orders – general principles

1. AIFM should establish and implement procedures and arrangements which provide for the prompt, fair and expeditious execution of orders on behalf of the AIF.

The procedures and arrangements implemented by AIFM should satisfy the following conditions:

- (a) ensure that orders executed on behalf of AIFs are promptly and accurately recorded and allocated;
- (b) execute otherwise comparable AIF orders sequentially and promptly unless the characteristics of the order or prevailing market conditions make this impracticable, or the interests of the AIF or of the investors of the AIF require otherwise.

AIFM should ensure that financial instruments, sums of money or other assets, received in settlement of the executed orders are promptly and correctly delivered to or registered in the account of the appropriate AIF.

2. AIFM should not misuse information relating to pending AIF orders, and shall take all reasonable steps to prevent the misuse of such information by any of its relevant persons.

Box 16

EFAMA welcomes the clarification in Explanatory Text 25 that Box 16 does not apply where the investment in assets is made after extensive negotiations on the terms of the agreement. Again, EFAMA strongly urges ESMA to include this clarification directly into the text of Box 16 to avoid diverging or contradictory future interpretations.

Box 17**Aggregation and allocation of trading order**

1. AIFM should not be permitted to carry out an AIF order in aggregate with an order of another AIF, a UCITS or a client or with an order made when investing their own funds, unless the following conditions are met:
 - (a) it must be unlikely that the aggregation of orders will work overall to the disadvantage of any AIF, UCITS or clients whose order is to be aggregated;
 - (b) an order allocation policy must be established and implemented, providing in sufficiently precise terms for the fair allocation of aggregated orders, including how the volume and price of orders determines allocations and the treatment of partial executions.
2. Where an AIFM aggregates an AIF order with one or more orders of other AIFs, UCITS or clients and the aggregated order is partially executed, it should allocate the related trades in accordance with its order allocation policy.
3. AIFM which have aggregated transactions for own account with one or more AIFs, UCITS or clients' orders should not allocate the related trades in a way that is detrimental to the AIF or a client.
4. If an AIFM aggregates an order of an AIF, UCITS or another client with a transaction for own account and the aggregated order is partially executed, it allocates the related trades to the AIF or to clients in priority over those for own account.

However, if the AIFM is able to demonstrate to the AIF or to the client on reasonable grounds that it would not have been able to carry out the order on such advantageous terms without aggregation, or at all, it may allocate the transaction for own account proportionally, in accordance with the policy as referred to in paragraph 1(b).

Box 17

EFAMA welcomes the clarification in Explanatory Text 27 that Box 11 does not apply where the investment in assets is made after extensive negotiations on the terms of the agreement. Again, EFAMA strongly urges ESMA to include this clarification directly into the text of Box 16 to avoid diverging or contradictory future interpretations.

Box 18**Inducements**

1. AIFM should not be regarded as acting honestly, fairly and professionally in accordance with the best interests of the AIF if, in relation to the activities of collective portfolio management of AIFs

(activities referred to in Annex I), they pay or are paid any fee or commission, or provide or are provided with any non-monetary benefit, other than the following:

- (a) a fee, commission or non-monetary benefit paid or provided to or by the AIF or a person on behalf of the AIF;
 - (b) a fee, commission or non-monetary benefit paid or provided to or by a third party or a person acting on behalf of a third party, where the AIFM can demonstrate that the following conditions are satisfied:
 - i. the existence, nature and amount of the fee, commission or benefit, or, where the amount cannot be ascertained, the method of calculating that amount, must be clearly disclosed to the investors of the AIF in a manner that is comprehensive, accurate and understandable, prior to the provision of the relevant service;
 - ii. the payment of the fee or commission, or the provision of the non-monetary benefit must be designed to enhance the quality of the relevant service and not impair compliance with the AIFM's duty to act in the best interests of the AIF.
 - (c) proper fees which enable or are necessary for the provision of the relevant service, including custody costs, settlement and exchange fees, regulatory levies or legal fees, and which, by their nature, cannot give rise to conflicts with the AIFM's duties to act honestly, fairly and professionally in accordance with the best interests of the AIF.
2. AIFM should be permitted, for the purpose of paragraph 1(b)(i), to disclose the essential terms of the arrangements relating to the fee, commission or non-monetary benefit in summary form, provided that the AIFM undertakes to disclose further details at the request of the investor and provided that it honours that undertaking.

Box 18

EFAMA has significant concerns regarding ESMA's proposals in Box 18 and the accompanying explanatory text.

According to ESMA's proposals, Box 18 should apply to all activities of collective portfolio management (including marketing, as specified in Para. 30 of the explanatory text). **Our members agree that these rules should apply to direct marketing by the AIFM, but they strongly disagree that they should apply to "indirect marketing", as indicated by ESMA².**

From a legal point of view, EFAMA does not believe that distribution via intermediaries constitutes part of the fund management services as specified in Annex I to the AIFMD. External intermediaries

² Para 30: "... where an investor pays subscription fees to an AIFM which are passed on to intermediaries for the marketing of the relevant AIF, the payment falls under paragraph 1(b) of Box 18."

who are not tied agents act in their own capacity and under their own responsibility. Their relationship to the AIFM is based upon distribution agreements which set out the duties and obligations of each party and ensure compliance with their respective legal requirements. Third-party distribution cannot be deemed part of the collective portfolio management activities and the term “marketing” in Para. 2 (b) of Annex I³ can only refer to direct distribution by the AIFM, by its tied agents, and possibly to marketing on behalf of the AIFM by a placing agent for a closed-end investment company IPO. **A clear statement by ESMA in this regard is crucial and this distinction should be included in the Commission's proposals for Level 2 implementing measures.**

Furthermore, the payment of distribution fees to remunerate the service of investment advice or distribution activities in general is not by nature “designed to enhance the quality of the collective portfolio management” (Para. 1 (b) (ii)). As discussed, such payments are mostly extraneous to collective portfolio management. From the AIFM's perspective, they should be rather considered as a necessary cost (“proper fees which enable or are necessary for the provision of the relevant service” according to Para. 1 (c)), as without that payment, no service would be rendered.

Even for payments to placing agents for closed-end investment company IPOs, it might be difficult to fulfill the requirement of Para. 1 (b) (ii) and we would therefore suggest the inclusion in the explanatory text of wording similar to Recital 39⁴ of the MiFID Level 2 Directive, to clarify that payment of marketing fees/commissions can be regarded as enhancing the quality of the service.

We suggest adding the following text:

“For the purposes of the provisions of this Directive concerning inducements, the payment by an AIFM of a commission in connection with marketing, in circumstances where compliance with the AIFM's duty to act in the best interest of the AIF is not impaired, should be considered as designed to enhance the quality of the collective portfolio management service.”

Most importantly, however, it is not necessary to consider third-party distribution payments as inducements in the sense of Para. 1 (b) in order to ensure investor protection. Fees and commissions received by intermediaries as remuneration for the distribution service are already regulated, subject to the conditions of Art. 26 (1) (b) of the MiFID Level 2 Directive and to disclosure to investors at the point of sale. There is no need to require the justification of the same payments in relation to collective portfolio management. The AIFM does, however, retain responsibility for managing conflicts of interest related to third-party distribution (covered under Section IV.III).

Some EFAMA members also consider that it is disproportionate to seek to restrict the payment/receipt of inducements as the Directive is aimed at AIFs marketed to professional investors, and it should be sufficient to rely upon the disclosure requirement in Para. 1 (b) (i). Article 43 of the

³ Marketing is defined in Article 4 (1) (x) of the Level 1 text as ‘... a direct or indirect offering or placement at the initiative of the AIFM or on behalf of the AIFM of units or shares of an AIF it manages to or with investors domiciled or with a registered office in the Union’.

⁴ ‘For the purposes of the provisions of this Directive concerning inducements, the receipt by an investment firm of a commission in connection with investment advice or general recommendations, in circumstances where the advice or recommendations are not biased as a result of the receipt of commission, should be considered as designed to enhance the quality of the investment advice to the client.’

Level 1 text permits Member States to allow marketing to retail investors on their territory, and in such cases stricter requirements could be imposed; Level 2 provisions should consequently be limited to the professional client market.

Lastly, contrary to ESMA's statements in Para. 30, we understand that the upcoming PRIIPs initiative will not cover marketing fees paid for third-party distribution except within the MiFID Review (and IMD review for insurance products), therefore any necessary measure regarding direct sales would have to be included in the respective sectoral Directives (UCITS, AIFMD).

Disclosures related to inducements in annual report

EFAMA strongly disagrees with ESMA's suggestion in Para. 32 of the Explanatory Text that details should be disclosed in the annual report. Firstly, there is no mandate in Level 1 for ESMA to advise the Commission on this issue.

Secondly, our members believe that disclosure in the annual report would be neither meaningful nor feasible: the disclosure would span a range of different arrangements and it would be extremely onerous to quantify and to consolidate all the information. Additionally, the disclosure in the annual report is at fund level, so to apportion, for instance, soft commissions across different funds, and to consolidate commissions/fees payable in respect of different transactions, would not result in meaningful information for investors. Soft commission arrangements cannot be disclosed because they are commercially sensitive. Some inducements cannot in many cases be attributed to specific funds as they are paid for services designed to enhance the quality of portfolio management in general.

If such disclosure was deemed necessary, it should take place ex-ante, in line with MiFID requirements. For this purpose, AIFM should be able to avail themselves of any appropriate durable medium, such as the AIFM's website.

Disclosure of inducements in relation to third-party distribution should in any case not be necessary in the AIF annual report, as it is already the duty of distributors under MiFID to provide final investors with details of inducements they have received.

Box 19

Fair treatment by an AIFM

Option 1

Fair treatment by an AIFM requires that no investor may obtain a preferential treatment that has an overall material disadvantage to other investors.

Option 2

Fair treatment by an AIFM includes that no investor may obtain a preferential treatment that has an overall material disadvantage to other investors.

Q17: Do you agree with Option 1 or Option 2 in Box 19? Please provide reasons for your view.

A broad majority of EFAMA Members prefers Option 1 in Box 19. They considered that Option 1 provided more legal certainty because it was perceived as giving clearer guidelines and leaving less room for diverging national interpretations.

Some EFAMA Members prefer Option 2, as long as such preferential terms may be made known to all other investors in an AIF.

Some EFAMA Members consider that neither Option 1 nor Option 2 were suitable and that fair treatment can be ensured by requiring AIFMs to disclose the existence and nature of preferential treatment as already required in the Level 1 text. They considered that the Level 1 text was sufficient and that no further detail was required at Level 2.

IV.III. Possible Implementing Measures on Conflicts of Interest

General Comment

EFAMA welcomes ESMA's approach to align conflicts of interest provisions for AIFM and in particular the fact that the proposals are to a large extent aligned with the established standards of the MiFID and UCITS Directive.

Box 20

Types of conflicts of interest between the various actors as referred to in Article 14(1)

For the purpose of identifying the types of conflicts of interest that arise in the course of managing AIFs, AIFM should take into account, by way of minimum criteria, the question of whether the AIFM, a relevant person or a person directly or indirectly linked by way of control to the AIFM

- (a) is likely to make a financial gain, or avoid a financial loss, at the expense of the AIF or its investors;
- (b) has an interest in the outcome of a service or an activity provided to the AIF or its investors or to a client or of a transaction carried out on behalf of the AIF or a client, which is distinct from the AIF interest in that outcome;
- (c) has a financial or other incentive to favour (i) the interest of a UCITS, a client or group of clients or another AIF over the interest of the AIF or (ii) the interest of one investor over the interest of another investor or group of investors of the same AIF;
- (d) carries on the same activities for the AIF and for another AIF, a UCITS or client; or

- (e) receives or will receive from a person other than the AIF or its investors an inducement in relation to collective portfolio management activities provided to the AIF, in the form of monies, goods or services other than the standard commission or fee for that service.

Box 20

EFAMA considers that the requirement for the identification of conflicts of interest, according to which the AIFM should take into account the situation of the relevant person, is very wide given the definition of “relevant person” on page 29. As currently drafted, this could suggest that the AIFM would need to take into account all types of conflicts of interest along the entire delegation chain and even internally to relevant persons. However, for various reasons, such as confidentiality and data protection, the relevant persons will not be allowed or willing to disclose to the AIFM the information which the AIFM would need to identify all conflicts of interest. EFAMA would therefore welcome a modification of Box 20.

Furthermore, EFAMA would appreciate clarifications regarding the term “client”, as there is no definition of “client” in the AIFMD. In order to avoid any misunderstanding, we suggest replacing “client” by the following wording: “any other contractual party”.

Box 21

Conflicts of interest policy

1. AIFM should establish, implement and maintain an effective conflicts of interest policy. That policy shall be set out in writing and shall be appropriate to the size and organisation of the AIFM and the nature, scale and complexity of its business.

Where the AIFM is a member of a group, the policy should also take into account any circumstances of which the AIFM is or should be aware which may give rise to a conflict of interest resulting from the structure and business activities of other members of the group.

2. The conflicts of interest policy established in accordance with paragraph 1 shall include the following:
 - (a) the identification of, with reference to the activities carried out by or on behalf of AIFM including activities carried out by a delegate, sub-delegate, external valuer or counterparty, the circumstances which constitute or may give rise to a conflict of interest entailing a material risk of damage to the interests of the AIF or its investors;
 - (b) procedures to be followed and measures to be adopted in order to manage such conflicts.

Box 21

The requirements in the ESMA proposal in Box 21 regarding conflicts of interest policy include activities carried out by delegates, sub-delegates, external valuers and counter- parties.

EFAMA understands that these requirements only apply regarding conflicts of interest between the AIFM itself and these entities. The AIFM should not be required to have regard to the internal conflicts of interest policies of any of these entities. Furthermore, the AIFM should not be required to have to look through to entities with which its delegates, sub-delegates, external valuers and counter-parties have relationships. This would be impossible because of business secrecy and confidentiality. There is also no similar requirement in the MiFID or UCITS Directives. EFAMA would appreciate if the text in Box 21 could be modified to more clearly reflect this.

Conflicts of interest between the AIFM and those entities with whom it has a direct relationship would in any case be identified and managed under the AIFM's own conflicts policy. Therefore, EFAMA suggests to delete the words "with reference to...counterparty" in 2(a).

Box 22

Independence in conflicts management

1. The procedures and measures provided for the management of conflicts of interest should be designed to ensure that relevant persons engaged in different business activities involving a conflict of interest carry on these activities at a level of independence appropriate to the size and activities of the AIFM and of the group to which it belongs, and to the materiality of the risk of damage to the interests of the AIF or its investors.
2. The procedures to be followed and measures to be adopted in accordance with paragraph 2(b) of Box 2 shall include the following where necessary and appropriate for the AIFM to ensure the requisite degree of independence:
 - (a) effective procedures to prevent or control the exchange of information between relevant persons engaged in collective portfolio management activities or other activities pursuant to Article 6(2) and (4) AIFMD involving a risk of a conflict of interest where the exchange of the information may harm the interest of one or more AIFs or its investors;
 - (b) the separate supervision of relevant persons whose principal functions involve carrying out collective portfolio management activities on behalf of, or providing services to clients or to investors whose interest may conflict, or who otherwise represent different interests that may conflict, including those of the AIFM;
 - (c) the removal of any direct link between the remuneration of relevant persons principally engaged in one activity and the remuneration of, or revenues generated by, different relevant persons principally engaged in another activity, where a conflict of interest may arise in relation to those activities;
 - (d) measures to prevent or limit any person from exercising inappropriate influence over the way in which a relevant person carries out collective portfolio management activities;
 - (e) measures to prevent or control the simultaneous or sequential involvement of a relevant person in separate collective portfolio management activities or other activities pursuant to Article 6(2) and (4) AIFMD where such involvement may impair the proper

Box 22 Para. 2b

EFAMA does not see the need for a separate supervision of the relevant persons.

Box 23

Record keeping of activities giving rise to detrimental conflicts of interest and way of disclosure of conflicts of interest

1. AIFM should keep and regularly update a record of the types of activities undertaken by or on behalf of the AIFM in which a conflict of interest entailing a material risk of damage to the interests of one or more AIFs or its investors has arisen or, in the case of an ongoing activity, may arise.
2. The AIFM shall disclose to investors by a durable medium or by means of a website (where that does not constitute a durable medium) provided that the conditions specified in paragraph 3 are satisfied
 - (a) conflicts of interest pursuant to Article 14(1) and (2) of the AIFM Directive, and
 - (b) where a delegation or sub-delegation of portfolio or risk management has taken place, conflicts of interest between the delegate or sub-delegate and the AIFM or the investors of the respective AIF.
3. Where an AIFM provides information to an investor by means of a website and that information is not addressed personally to the investor, the AIFM should ensure that the following conditions are satisfied:
 - (a) there is evidence that the investor has regular access to the internet. The provision by the investor of an e-mail address shall be treated as such evidence;
 - (b) the investor must specifically consent to the provision of that information in that form;
 - (c) the investor must be notified electronically of the address of the website, and the place on the website where the information may be accessed;
 - (d) the information must be up to date;
 - (e) the information must be accessible continuously by means of that website for such period of time as the investor may reasonably need to inspect it.

Box 23 Para. 2

EFAMA understands that the AIFM is only required to disclose actual (and not potential) conflicts of interest. Furthermore, EFAMA believes that the disclosure of conflicts of interest should be limited to those that cannot be managed, rather than all. This is aligned with the MiFID regime which places the focus on those conflicts of interest which cannot be managed. This would also allow to disclose only meaningful information and not to overload regulators and investors with information.

Box 23 Para. 3

In case of indirect distribution or of trading of parts of the AIF on a secondary market (for example listed AIF), an AIFM has no direct contact with the investors. The AIFM therefore cannot ensure that the conditions in Box 23 Para 3 are met. EFAMA urges ESMA to modify the requirements of Box 23 Para. 3.

Box 24

Strategies for the exercise of voting rights

1. AIFM should develop adequate and effective strategies for determining when and how any voting rights held in the managed portfolios are to be exercised, to the exclusive benefit of the AIF and its investors concerned.
2. The strategy referred to in paragraph 1 should determine measures and procedures for:
 - (a) monitoring relevant corporate actions;
 - (b) ensuring that the exercise of voting rights is in accordance with the investment objectives and policy of the relevant AIF;
 - (c) preventing or managing any conflicts of interest arising from the exercise of voting rights.
3. A summary description of the strategies and details of the actions taken on the basis of those strategies shall be made available to the investors on their request

Box 24

EFAMA welcomes the alignment of the ESMA proposal on the exercise of voting rights with the existing UCITS framework.

As mentioned in the EFAMA reply to the EU Commission Consultation on the Green Paper Corporate Governance in Financial Institutions (COM(2010)284), EFAMA considers that in addition to these requirements, no further mandatory adherence to codes of best practice should be envisaged, but rather left to the discretion of the institutional investors' self-regulation efforts.

EFAMA considers the question of shareholder engagement as of the greatest importance and has therefore issued self-regulation in this field by publishing in May 2011 its EFAMA Code for External Governance. The EFAMA Code for External Governance shall provide a European wide standard which is neither designed to supersede applicable law and regulations nor to replace national self-regulation. It should instead allow mutual recognition of national codes which at least reflect its principles. EFAMA Members should, as applicable, publicly confirm adherence to the EFAMA Code for External Governance or to their relevant national code.

IV.IV. Possible Implementing Measures on Risk Management

General Comments

EFAMA is grateful for ESMA's acknowledgment of proportionality in several parts of the explanatory text, but proportionality needs also to be explicitly included in the relevant text boxes in this section.

Box 25

Permanent Risk Management Function

1. The AIFM shall establish and maintain a permanent risk management function that shall:
 - (a) implement effective risk management policies and procedures in order to identify, measure, manage and monitor on an ongoing basis all risks relevant to each AIF's investment strategy, to which each AIF is or may reasonably be exposed;
 - (b) ensure that the risk profile of the AIF disclosed to investors in accordance with Article 23(4)c of Directive 2011/61/EU, is consistent with the risk limits that have been set in accordance with Box 29;
 - (c) monitor compliance with the risk limits set in accordance with Box 29 and notify the AIFM's governing body and where it exists the AIFM's supervisory function in a timely manner when it considers the AIF's risk profile is inconsistent with these limits or where it is aware there is a material risk that it will be inconsistent with these limits;
 - (d) provide the following regular updates to the governing body of the AIFM and where it exists the AIFM's supervisory function at a frequency which is in accordance with the nature, scale and complexity of the AIF and/or the AIFM's activities:
 - (i) the consistency between and the compliance with, the risk limits set out in [Box 29, Risk Limits] and the risk profile of that AIF as disclosed to investors in accordance with Article 23(4)(c) of Directive 2011/61/EU; and
 - (ii) the adequacy and effectiveness of the risk management process, indicating in particular whether appropriate remedial measures have or will be taken in the event of any actual or anticipated deficiencies; and
 - (e) provide regular updates to the senior management outlining the current level of risk incurred by each managed AIF and any actual or foreseeable breaches to any risk limits set out in Box 29, so as to ensure that prompt and appropriate action can be taken.
2. The AIFM shall ensure that the permanent risk management function shall have the necessary authority and access to all relevant information necessary to fulfil the tasks set out in paragraph 1.

Box 25

No Comments

Box 26

Risk Management Policy

1. AIFM shall establish, implement and maintain an adequate and documented risk management policy which identifies all the relevant risks to which the AIF they manage are or might be

exposed to.

2. The risk management policy shall comprise such procedures as are necessary to enable the AIFM to assess for each AIF it manages the exposure of that AIF to market, liquidity and counterparty risks, and the exposure of the AIF to all other relevant risks, including operational risks, which may be material for each AIF it manages.
3. AIFM shall address at least the following elements in the risk management policy:
 - (a) the techniques, tools and arrangements that enable them to comply with the obligations set out in Box 28;
 - (b) the techniques, tools and arrangements that enable the assessment and monitoring of the liquidity risk of the AIF, under normal and exceptional liquidity conditions including through the use of regularly conducted stress tests in accordance with Box 33;
 - (c) the allocation of responsibilities within the AIFM pertaining to risk management;
 - (d) the limits set in accordance with Box 29 and a justification of how these are aligned with the risk profile of the AIF disclosed to investors in accordance with Article 23(4)(c) of Directive 2011/61/EU; and
 - (e) where the risk management function is not functionally or hierarchically separate the AIFM shall include a description of the safeguards referred to in Box 30 that allow for an independent performance of the risk management function. This description shall include:
 - (i) the nature of the conflict of interest;
 - (ii) the remedial measures put in place;
 - (iii) the reasons why this measure should be reasonably expected to result in an independent performance of the risk management function; and
 - (iv) how the AIFM expects to ensure that the safeguards are consistently effective.
4. AIFM shall ensure that the risk management policy referred to in paragraph 1, 2 and 3 states the terms, contents and frequency of reporting of the risk management function referred to in Box 25 to those charged with governance, to senior management and, where it is appropriate, the supervisory function.
5. For the purposes of paragraphs 1-4, AIFM shall take into account the nature, scale and complexity of their business and of the AIF it manages.

Box 26

Para. 1(a) of Box 26 – We believe that the language should be in line with Para. 1 (a) of Box 25 ('risks ...to which each AIF is or may reasonably be exposed', therefore "reasonably" should be added.

Box 27

Assessment, monitoring and review of the risk management policy

1. AIFM shall assess, monitor and periodically review:
 - (a) the adequacy and effectiveness of the risk management policy and of the arrangements,

- processes and techniques referred to in Box 28;
- (b) the level of compliance by the AIFM with the risk management policy and with the arrangements, processes and techniques referred to in Box 28;
 - (c) the adequacy and effectiveness of measures taken to address any deficiencies in the performance of the risk management process; and
 - (d) the measures set out in the risk management policy to ensure the functional and hierarchical separation of the risk management function in accordance with Box 30.
2. AIFM shall notify the competent authorities of their home Member State of any material changes to the risk management policy and of the arrangements, processes and techniques referred to in Box 28.
3. AIFM shall ensure that the periodic review in accordance with paragraph 1 is carried out:
- (a) at a set frequency which is in accordance with the principle of proportionality including its appropriateness given the nature, scale and complexity of their business and the AIF it manages, that frequency being at least annual;
 - (b) when material changes are made to the risk management policy and of the arrangements, processes and techniques referred to in Box 28;
 - (c) when internal or external events indicate that an additional review is required; and
 - (d) when material changes are made to the investment strategy and objectives of an AIF the AIFM manages.

Box 27

Paragraph 2 – EFAMA believes that this paragraph should be aligned with the wording of Art. 39 (2) of the UCITS Implementing Directive 2010/43/EU as follows:

“AIFM shall notify the competent authorities of their home Member State of any material changes to the risk management process.”

The proposed text appears too detailed, and not in line with a principle-based approach.

Box 28

Measurement and Management of Risk

1. AIFM shall adopt adequate and effective arrangements, processes and techniques in order to:
- (a) identify, measure, manage and monitor at any time the risks to which the AIF under their management are or might be exposed to including those sources of risk the AIFM incurs on behalf of the AIF; and
 - (b) ensure compliance with the limits set in accordance with Box 29.

2. Those arrangements, processes and techniques referred to in paragraph 1 shall be proportionate to the nature, scale and complexity of the business of the AIFM and of the AIF they manage and shall be consistent with the AIF risk profile as disclosed to investors in accordance with Article 23(4)(c) of Directive 2011/61/EU.
3. For the purposes of paragraph 1, AIFM shall take the following actions for each AIF they manage:
 - (a) put in place such risk measurement arrangements, processes and techniques as are necessary to ensure that the risks of positions taken and their contribution to the overall risk profile are accurately measured on the basis of sound and reliable data and that the risk measurement arrangements, processes and techniques are adequately documented;
 - (b) conduct periodic back-tests in order to review the validity of risk measurement arrangements which include model-based forecasts and estimates;
 - (c) conduct periodic stress tests and scenario analyses, on the basis of reliable and up-to-date information, both in quantitative and qualitative terms to address risks arising from potential changes in market conditions that might adversely impact the AIF;
 - (d) ensure that the current level of risk complies with the risk limit policy and procedures as set out in accordance with Box 29;
 - (e) establish, implement and maintain adequate procedures that, in the event of actual or anticipated breaches of the risk limit policy and procedures of the AIF, result in timely remedial actions in the best interests of investors; and
 - (f) ensure that there are appropriate liquidity management processes for each AIF in line with the requirements set out in Box 32.

Box 28

Paragraph 1 (a) – EFAMA considers that the requirements are much more extensive than those in the UCITS Directive, and the wording *“including those sources of risk the AIFM incurs on behalf of the AIF”* should be deleted. Furthermore, the language should be in line with Para. 1 (a) of Box 25 (*‘risks ...to which each AIF is or may **reasonably** be exposed’*), therefore ***“reasonably”*** should be added.

Paragraphs 3 (b) and 3 (c) –We suggest further alignment with the UCITS Implementing Directive 2010/43/EU as follows:

- (a) “conduct, **where appropriate**, periodic back-tests in order to review the validity of risk measurement arrangements which include model-based forecasts and estimates;
- (b) conduct, **where appropriate**, periodic stress tests and scenario analyses, on the basis of reliable and up-to-date information (...)”

The addition to the text is required by the need to reflect differentiation of standards depending on the type of AIF, its investment strategy and portfolio assets.

Box 29

Risk Limits

1. AIFM shall establish and implement quantitative and/or qualitative risk limits for each AIF they manage, taking into account all relevant risks. Where only qualitative limits are set the AIFM shall be able to justify this approach to the relevant competent authority.
2. The qualitative and quantitative risk limits for each AIF shall, at least, cover the following risks:
 - (a) market risks;
 - (b) credit risks;
 - (c) liquidity risks;
 - (d) counterparty risks; and
 - (e) operational risks.

When setting risk limits AIFM shall take into account the strategies and assets employed in respect of each AIF it manages as well as the national rules applicable to each of those AIF. These risk limits should be aligned with the risk profile of the AIF as disclosed to investors in accordance with Article 23(4)(c) of Directive 2011/61/EU and approved by the governing body.

Box 29

EFAMA has some general comments on this box, which we believe should be reflected in the drafting:

- Limits are different from procedures, and in some cases (for example for operational risks in Para. 2 (e)), it is not possible to set specific limits.
- Limits would not be set in some cases at AIF level, but at the level of the AIFM.

Paragraph 2 – Contrary to Box 26, there is no reference in this Box to relevance or materiality. Our members consider that it should be added in Para. 2 as follows:

“The qualitative and quantitative risk limits for each AIF shall, at least, cover the following risks where relevant:”

Box 30

Functional and Hierarchical Separation of the Risk Management Function

1. The risk management function of an AIFM may be said to be functionally and hierarchically separate from the operating units, including the portfolio management function, where all the following conditions are satisfied:
 - (a) Those engaged in the performance of the risk management function are not supervised

- by those responsible for the performance of the operating units, including the portfolio management function, of the AIFM;
- (b) Those engaged in the performance of the risk management function are not engaged in the performance of activities within the operating units, including the portfolio management function;
 - (c) Those engaged in the performance of the risk function are compensated in accordance with the achievement of the objectives linked to that function, independent of the performance of the other conflicting business areas;
 - (d) The remuneration of the senior officers in the risk management functions is directly overseen by the remuneration committee, where the AIFM is sufficiently significant in terms of its size or the size of the AIF it manages, its internal organisation and the nature, the scope and the complexity of its activities to have established such a committee; and
 - (e) The separation is ensured up to the governing body of the AIFM.
2. The functional and hierarchical separation of the functions of risk management in accordance with paragraph 1 shall be reviewed by the competent authorities of the home Member State of the AIFM in line with the principle of proportionality, in the understanding that the AIFM shall in any event be able to demonstrate that specific safeguards against conflicts of interest allow for the independent performance of risk management activities.
3. The governing body of the AIFM, and where it exists the supervisory function, shall review the risk management function in accordance with paragraph 1. Where compliance cannot be achieved the governing body of the AIFM, and where it exists the supervisory function, shall identify material conflicts of interest that may pose a risk to the independent performance of risk management activities and shall ensure that procedures are in place which may reasonably be expected to result in an independent performance of the risk management function. These safeguards shall be documented in the risk management policy and must include (a), (b), (c) and (e) and may also include (d) and (f) where this is proportionate taking into account the nature, scale and complexity of the AIFM:
- (a) procedures to ensure that the data used by the risk management function in making decisions is reliable and subject to an appropriate degree of control by the risk management function so as to allow for the independent performance of its duties;
 - (b) that staff members engaged in risk management are compensated in accordance with the achievement of the objectives linked to the risk management function, independent of the performance of the business areas in which they are engaged;
 - (c) that key risk management function is subject to an appropriate independent review to ensure that decisions are being arrived at independently;
 - (d) that there is a review of the risk management function by an independent external party or, where applicable the internal audit function;
 - (e) segregation of conflicting duties; and
 - (f) an appropriately resourced risk committee that reports directly to the AIFM's governing body where the non-independent members of such a committee do not have undue influence over the process.

4. The safeguards referred to in paragraph 3 must be subject to regular review by the governing body of the AIFM, and where it exists the supervisory function, which shall require timely remedial action to be taken to address deficiencies.

Box 30

EFAMA would welcome more clarity regarding how the risk management function shall be functionally and hierarchically separated from the operating units, including the portfolio management function.

In this context, we suggest clarifying the meaning of the term 'operating units'. In our view, only the portfolio management function can be considered an operating unit which shall not be responsible for risk management tasks such as identifying, measuring, managing and monitoring of the relevant risks of AIF. On the other hand, the separation requirement should certainly not pertain to units engaged in investment compliance, monitoring of risk limits, fund accounting, fund reporting and comparable tasks. Furthermore, the legal and compliance department and the units for marketing and distribution are not operating units which shall be functionally and hierarchically separated from the risk management function.

Paragraph 1 (c) – The requirement that *"Those engaged in the performance of the risk function are compensated in accordance with the achievement of the objectives linked to that function, **independent** of the performance of the other conflicting business areas"* is unrealistic, since performance of the other business areas will determine the total amount of money available for compensation. The wording "**not directly linked to**" would be more appropriate than *"independent"*.

Paragraph 1 (e) – ESMA requires separation to be ensured up to the governing body of the AIFM, whereas EFAMA members believe that it should be sufficient to ensure such separation up to senior management level. Such provision is unlikely to be met by many AIFMs and it will be difficult for small self-managed funds to meet it.

Paragraph 3 - Concerning the provision of safeguards for independent performance of the risk management function in case of identified material conflicts of interest, EFAMA members strongly disagree with ESMA's proposal to document such safeguards in the risk management policy. Such safeguards should rather be implemented within the general management process of conflicts of interests and documented in the conflicts of interest policy of the AIFM. Otherwise, there could be a double obligation for monitoring of conflicts of interest.

The provisions in Para. 1 (a) are unlikely to be met by many AIFMS, particularly by small and medium-sized ones. It is therefore very important that the requirements in Para. 3 be applied proportionately and appropriately. The risk exists that the requirements in Box 30 – being very prescriptive – might prove very difficult for smaller firms and constitute a barrier to entry.

Q18: ESMA has provided advice as to the safeguards that it considers AIFM may apply so as to achieve the objective of an independent risk management function. What additional safeguards should AIFM employ and will there be any specific difficulties applying the safeguards for specific types of AIFM?

No additional safeguards are required. Please see our comments above.

Q19: ESMA would like to know which types of AIFM will have most difficulty in demonstrating that they have an independent risk management function? Specifically what additional proportionality criteria should be included when competent authorities are making their assessment of functional and hierarchical independence in accordance with the proposed advice and in consideration of the safeguards listed?

Please see our comments above. Furthermore, some EFAMA members consider that smaller AIFMs or AIFMs that invest in more specialist instruments such as real estate and private equity will have the most difficulty, because market data is not as readily available as for more liquid asset classes such as equities and fixed income.

IV.V. Possible Implementing Measures on Liquidity Management

Box 31

Liquidity Management Definitions

‘Special arrangement’ means an arrangement that arises as a direct consequence of the illiquid nature of the assets of an AIF which impact the specific redemption rights of investors in a class of units or shares of the AIF and which is a bespoke or separate arrangement from the general redemption rights of investors.

Box 31

In Box 31 ESMA uses the term ‘class’ of unit/share. For regulated funds in some jurisdictions, this term has a specific meaning and the rights of a ‘class’ of unit/share must have the same rights to participate in the property of a scheme as other classes in the same scheme. This would imply that if certain assets were illiquid, all classes (and therefore all investors) would have the same rights to participate in those assets, which may not be the case for some “special arrangements”. We therefore recommend using wording such as ‘type’ of unit/share, which does not have a special meaning in Member States.

Some EFAMA members consider that ESMA should clarify that special arrangements must not be automatically implemented, but that their use is at the discretion of the AIFM, as long as such arrangements are foreseen by fund rules.

Explanatory text Paragraph 9 – We recommend that the words “such as gates” be deleted from the last line. Firstly, “gates” is not a defined term, although the IOSCO consultation report “Principles on Suspension of Redemptions in Collective Investment Schemes” (issued March 2011) defines them on page 15 as a constraint in redemption amounts to a specific proportion on any one day. Secondly, Para. 8 and 9 imply that a special arrangement applies to specific assets, not to the entire fund and all investors. Gates, on the contrary, do not relate to certain assets but rather all assets and are not bespoke as they would apply to all investors where their redemption orders exceed the gate limit. It might be helpful for ESMA to clarify further what “special arrangements” are: in Para. 9 on page 58, for example, special arrangements are equated to side letters⁵.

Box 32

Liquidity Management Policies and Procedures

1. AIFMs shall, for each AIF that they manage that is not an unleveraged closed-ended AIF, adopt appropriate liquidity management policies and procedures enabling them to monitor the liquidity risk of each AIF and comply with their underlying obligations to investors, counterparties, creditors and other parties. AIFMs for each AIF that they manage that is a leveraged closed-ended AIF, shall not be required to comply with paragraphs 3(c), 3(f) to 3(g) and Paragraph 1 of Box 33.
2. In order to comply with their obligations under paragraph 1, AIFMs shall be able to demonstrate to the competent authorities of its home Member State that appropriate and effective liquidity management policies and procedures are in place taking into account the investment strategy, the liquidity profile and the redemption policy of each AIF.
3. Having regard to the alignment of the investment strategy, liquidity profile and redemption policy, AIFMs shall, for each AIF they manage, implement the following policies and procedures in order to comply with their obligations under Article 16 (1) of Directive 2011/61/EU:
 - (a) AIFMs shall maintain a level of liquidity in the AIF appropriate to its underlying obligations, based on an assessment of the relative liquidity of the AIF's assets in the market, taking account of the time required for liquidation and the price or value at which those assets can be liquidated, and their sensitivity to other market risks or factors;
 - (b) AIFMs shall monitor the liquidity profile of the portfolio of the AIF's assets, having regard to the marginal contribution of individual assets which may have a material impact on liquidity, and the material liabilities and commitments (contingent or otherwise) which the AIF may have in relation to its underlying obligations. For these purposes AIFMs shall take in to account the pro-file of their investor base including the type of investors in the AIF, the relative size of investments and the redemption terms to which these investments are subject;
 - (c) AIFMs shall, where the AIF invests in other collective investment undertakings, monitor the approach adopted by the managers of those other collective investment undertakings to the management of liquidity, including through conducting periodic reviews, to monitor changes

⁵ “By special arrangement (so-called ‘side-letter’), the AIFM grants an investor redemption rights that are preferential in terms from the general redemption rights given to other investors.”

to the redemption provisions of the underlying collective investment undertakings in which the AIF invests. Notwithstanding the requirements of paragraph 1, this provision shall not apply where the other collective investment undertaking in which the AIF invests is actively traded on a regulated market within the meaning of Article 4 (1) (14) of Directive 2004/39/EC or an equivalent third country market;

- (d) AIFMs shall implement and maintain appropriate liquidity measurement arrangements and procedures to assess the quantitative and qualitative risks of positions and of intended investments which have a material impact on the liquidity profile of the portfolio of the AIF's assets to enable their effects on the overall liquidity profile to be appropriately measured. The procedures employed shall ensure that AIFMs have the appropriate knowledge and understanding of the liquidity of the assets in which the AIF has invested or intends to invest including, where applicable, the trading volume and sensitivity of prices and/or spreads of individual assets in normal and exceptional liquidity conditions;
- (e) In accordance with the requirements of Article 23 (1) (h) of Directive 2011/61/EU AIFMs shall implement appropriate policies and procedures to ensure that the redemption policies of the AIF are disclosed to investors, in sufficient detail and with sufficient prominence, before they invest in the AIF and in the event of material changes;
- (f) AIFMs shall consider and put in to effect the tools and arrangements necessary to manage the liquidity risk of each AIF under its management. AIFMs shall identify the types of circumstances where tools and arrangements will be used in both normal and exceptional circumstances, taking into account the fair treatment of all AIF investors, in relation to each AIF under management. AIFMs may only use such tools and arrangements in these circumstances and if appropriate disclosures have been made in accordance with point (e);
- (g) AIFMs shall identify, manage and monitor conflicts of interest arising between investors wishing to redeem their investment(s) and those investors wishing to maintain their investment(s) in the portfolio, and any conflicts between the AIFMs incentive to invest in illiquid assets and the AIF's redemption policy in accordance with their obligations under Article 14 (1) of Directive 2011/61/EU;
- (h) AIFMs shall document their liquidity management policies and procedures, review these on at least an annual basis and update these for any changes or new arrangements; and
- (i) AIFMs shall include appropriate escalation measures in their liquidity management policies and procedures to address anticipated or actual liquidity shortages, or other distressed situations of the AIF.

Box 32

EFAMA believes it is important that Para. 1 of Box 32 should include a reference to appropriateness and proportionality, rather than the concept simply being reflected in the explanatory text in Para. 12 (*"These general requirements should be capable of calibration in an appropriate and proportionate manner which duly reflects the specific characteristics of the AIF including legal structure and national legislation"*).

Paragraphs 2 and 3 state that effective liquidity management policies and procedures need to take into account the liquidity profile of each AIF. We believe that the liquidity profile is the outcome of the implementation of the liquidity policy and procedures rather than an input.

Paragraph 3(b) – In some cases (for example for retail funds) the actual investor base may be unknown to the AIFM, and therefore the monitoring of the liquidity profile should be based on the type of investors targeted by the AIF.

Paragraph 3(c) – Where an AIF invests in an AIF whose AIFM is subject to the Directive, it should not be necessary for the investing fund's AIFM to *'monitor the approach adopted by the managers of those other collective investment undertakings ('CIU') to the management of liquidity, including through conducting periodic reviews, to monitor changes to the redemption provisions of the underlying CIU in which the AIF invests.'* The obligation for the underlying AIF to meet Article 16 and also the liquidity-related transparency requirements in Articles 23 make the need to monitor such managers' approaches to liquidity unnecessary. Rather, there should be a requirement to review disclosures received in accordance with Article 23 and their impact upon the AIFM's obligations under Article 16. There should therefore be a distinction in the requirements in Para. 3 (c) for investment in AIFs subject to the Directive vs. the requirements for investment in other CIUs. Furthermore, in the last sentence the word *"actively"* should be deleted, as it is unclear and undefined. The exemption at the end of this paragraph should also be extended to CIUs traded on an MTF.

Paragraph 3(d) – We recommend that **'where applicable and available'** be added the end of line 6 as some data may not be available. For example, post-trade transparency obligations can vary by type of instrument and some information may not be publicly available.

It would also be helpful if the text of the advice also recognised that the impact of exceptional liquidity conditions which have not been encountered before may difficult or impossible to predict. Where that is the case, assessment as to impact can only be on a best effort basis.

Paragraph 3(e) – All the information to be disclosed to meet the requirements of Article 23 is important. We question the requirement for *'sufficient prominence'* as this might suggest that some information should be given more prominence than other matters to be disclosed. We think the intention of the Directive is that all matters should be given the same degree of prominence and therefore recommend deletion of *'sufficient prominence'*. Regarding the requirement to disclose redemption policies in *'sufficient detail'*, EFAMA members believe that they should be disclosed in general terms, and further details made available upon request.

Furthermore, it should be clarified that Para. 3 (e) is not relevant to closed-ended funds.

Paragraph 3(f) – EFAMA recommends that *'will'* be replaced by **'may'** in line 3, to reflect the fact that the AIFM may have available a number of tools which it can use in a type of circumstance. For example, it may have a choice of deferring redemption, borrowing or carrying out an in specie redemption. It should be sufficient that an AIFM's systems and procedures set out the tools it may use in each type of circumstance.

This paragraph also introduces a strict obligation that liquidity tools can only be employed in disclosed circumstances. Given that AIFMs would only use such tools when it was in the AIF investors' best interests, some EFAMA members consider that this may be too strict a requirement, and it would therefore be appropriate to permit wider use, subject to competent authority approval.

Paragraph 3(h) – EFAMA considers that the requirement in Para. 3(h) to update the liquidity management and procedures for “*any changes or new arrangements*” is overly burdensome and should be modified to foresee an update for “*any material changes or new arrangements*”.

Explanatory text Paragraph 15 – The requirement that “AIFMs are required to consider not only their obligations to investors, but also their obligations to counterparties, creditors and other third parties” seems excessively broad and unclear, as it covers unspecified “third parties”.

Explanatory text Paragraph 18 – Please see also our comments above regarding ‘*sufficient prominence*’ in Para. 3 (e).

Explanatory text Paragraph 25 – Regarding the requirement to disclose redemption policies including escalation measures, EFAMA members believe that redemption policies should be disclosed in general terms, and further details made available upon request. The principles underpinning the policies and procedures may be disclosed, but not the practical details of the implementation of those principles.

Please see also our comments above regarding ‘*sufficient detail*’ in Para. 3 (e).

Box 33

Liquidity Management Limits and Stress Tests

1. AIFMs shall, where appropriate, considering the nature, scale and complexity of each AIF they manage, implement and maintain adequate limits for the liquidity/illiquidity of the AIF consistent with its redemption policy in accordance with the overarching requirements in Box 29 (Risk Limits) relating to quantitative and qualitative limits. AIFMs shall monitor compliance with these limits and where the limits are exceeded or likely to be exceeded AIFMs shall determine what course of action is required.
2. In accordance with their obligations in Article 16 (1) of Directive 2011/61/EU AIFMs shall regularly conduct stress tests, under normal and exceptional liquidity conditions, which enable them to assess the liquidity risk of each AIF under their management. The stress tests shall:
 - (a) be conducted on the basis of reliable and up-to-date information in quantitative terms or where this is not appropriate, in qualitative terms;
 - (b) where appropriate, simulate a shortage of the liquidity of the assets in the AIF as well as atypical redemption requests;
 - (c) cover market risks and any resulting impact, including on margin calls, on collateral requirements or credit lines;

- (d) account for valuation sensitivities under stressed conditions; and
- (e) be conducted at a frequency which is appropriate to the nature of the AIF, taking in to account the investment strategy, liquidity profile, type of investor and redemption policy of the AIF, but, at a minimum, annually.

3. AIFMs shall act in the best interests of investors in relation to the outcome of any stress tests. AIFMs shall consider the adequacy of the liquidity management policies and procedures, the appropriateness of the liquidity profile of the AIF's assets and the effect of atypical levels of redemption requests in determining any appropriate action.

Box 33

Paragraph 1 – We suggest that the penultimate line be modified as follows: 'where the limits are exceeded or likely to be exceeded AIFMs shall determine what course of action, **if any**, is required.' The addition of 'if any' makes clear that the AIFM may determine that no action is required (as stated in paragraph 26 of the related explanatory text).

Paragraph 2 (c) requires that market risks have to be covered when the AIFM conducts a stress test to assess the liquidity risk. Some EFAMA members are of the opinion that different types of risks should be assessed separately. Market risks should not be included in the assessment of liquidity risks, otherwise no clear result can be obtained regarding the liquidity of the AIF.

Paragraph 2 (d) requires the AIFM to: "account for valuation sensitivities under stressed conditions". In our opinion the text is too vague, as it does not clarify either under which valuation conditions it is relevant, or how it has to be assessed and reported:

- There is no differentiation with regard to marking-to-market and marking-to-model. With marking-to-market stressed conditions pose liquidity risk (no trades at all or all market participants wanting to sell), whereas with marking-to-model the valuation model may be unable to cope with stress conditions because of extreme or unobservable inputs.
- "account for": Does this mean that valuation sensitivities for certain explicit stress scenarios have to be assessed? If so, global or specific scenarios?

Paragraph 3 – EFAMA considers that the requirement should be to act in the best interests **of the AIF** (not of investors) taking into account the redemption policy of the AIF. Investors' interests may differ and it may not be possible to reconcile them.

Explanatory text Paragraph 28 – The reference to the "impact of anticipated AIF performance relative to peers" should be deleted, as it is impossible to predict the future performance of an AIF relative to its peers.

Explanatory text Paragraph 29 – This paragraph should also be amended to take into account the comments made in relation to Box 33, paragraph 3.

Box 34

Alignment of investment strategy, liquidity profile and redemption policy

1. For the purposes of Article 16 (2) of Directive 2011/61/EU the investment strategy, liquidity profile and redemption policy for each AIF managed by an AIFM shall be considered to be aligned when investors have the ability to redeem their investments:
 - (a) in a manner consistent with the fair treatment of all AIF investors; and
 - (b) in accordance with the AIF redemption policy and its obligations.
2. In assessing the alignment of the investment strategy, liquidity profile and redemption policy the AIFM shall also have regard to the impact that redemptions may have on the underlying prices and/or spreads of the individual assets of the AIF.

Box 34

Paragraph 1 (a) – As already stated in reference to Para. 3 of Box 33, individual investors' interests may differ. The investment strategy, liquidity profile and redemption policy should be considered aligned when investors have the ability to redeem their investments in accordance with the AIF's redemption policy and its obligations. Para. (a) should therefore be deleted.

Q20: It has been suggested that special arrangements such as gates and side pockets should be considered only in exceptional circumstances where the liquidity management process has failed. Do you agree with this hypothesis or do you believe that these may form part of normal liquidity management in relation to some AIFs?

A large majority of EFAMA members consider that gates and side pockets should be considered as normal liquidity management tools (and not used only in exceptional circumstances when the liquidity management process has failed), provided that investors are aware of their possible use by the AIFM.

If investors wish to have exposure to potentially illiquid investments and understand that there may be circumstances in which deferral of redemptions may be necessary, it would not be in the interests of those investors to restrict the AIF's ability to invest because liquidity requirements do not allow for deferred redemptions. Professional investors may make a conscious choice to invest in less liquid assets with the expectation of a higher return in the longer term, and their investment choices should not be limited.

Furthermore, both gates and side pockets should be available for the protection of investors, and do not necessarily indicate a failure of the AIFM's liquidity management process.

Some EFAMA members wish to stress the importance of a harmonized implementation of the use of special arrangements across the European Union.

Q21: AIFMs which manage AIFs which are not closed ended (whether leveraged or not) are required to consider and put into effect any necessary tools and arrangements to manage such liquidity risks. ESMA's advice in relation to the use of tools and arrangements in both normal and exceptional circumstances combines a principles based approach with disclosure. Will this approach cause difficulties in practice which could impact the fair treatment of investors?

Please see our comments above.

Q22: Do you agree with ESMA's proposed advice in relation to the alignment of investment strategy, liquidity profile and redemption policy?

EFAMA broadly agrees with ESMA's proposed advice, with the above-mentioned exceptions.

IV.VI. Investment in Securitisation Positions

General Remarks

EFAMA understands that ESMA's proposed advice regarding requirements for investment in securitisation positions aims at a level playing field with the requirements under the CRD framework. While the requirements broadly go into the same direction, some important differences remain and the proposed advice should ideally be modified to create the envisaged level playing field.

For example, requiring AIFMs to verify that the originator, sponsor or original lender retains a net economic interest of at least 5% would go beyond the requirements in the CRD. This would create an unlevel playing field. EFAMA fears that the proposed draft implementing measures will place a high burden on an AIFM investing in securitisation positions. The requirements to monitor the retention of the 5% interest by the originator, to take corrective action if the 5% limit is breached and to perform due diligence on the originator's credit granting procedures seem excessively burdensome. It is also questionable whether they can at all be complied with in practice. As a result it can unfortunately be expected that most AIFMs will refrain from investments in securitisation positions.

Furthermore, the term "tradable securities and other financial instruments based on repackaged loans" used by ESMA displays some important differences compared to the CRD wording as it lacks any reference to tranching and appears to limit the relevant securitisation underlying to loans. In our view, such modification of terms will lead to an unlevel playing field. EFAMA suggests aligning the requirements more closely with the CRD.

3. Appropriate requirements with respect to Article 17(1)(a) AIFMD: requirements that need to be met by the originator, the sponsor or the original lender

Box 35**Requirements for retained interest**

1. AIFM should only assume exposure to tradable securities and other financial instruments based on repackaged loans on behalf of one or more AIF if the originator, sponsor or original lender has explicitly disclosed to the AIFM in the documentation governing the securitisation that it will retain, on an ongoing basis, a net economic interest which in any event should not be less than 5%. The net economic interest should be determined at the origination and, if later, at the date of assumption of exposure by the AIFM and should be maintained on an ongoing basis.
2. There are circumstances in which there are entities that meet the definition of originator or sponsor, or fulfil the role of original lender; however, another entity that neither meets the definition of sponsor or originator, nor fulfils the role of original lender – but whose interests are most optimally aligned with those of investors – may seek to fulfil the retention requirement. For the avoidance of doubt, such other entity is not obliged to fulfil the retention requirement according to paragraph 1 if the retention requirement is fulfilled by the originator, sponsor or original lender.
3. In cases where it becomes apparent to the AIFM after the assumption of exposure to the securitisation that the disclosure of the net economic interest was incorrect at the time of the assumption of the exposure, i.e. the disclosure did not meet all relevant requirements laid out in this advice, corrective action should be taken by the AIFM with respect to such exposure taking into account the best interests of the investors of the relevant AIF. In cases where the net economic interest to be retained becomes less than 5% at a given moment after the assumption of the exposure, the AIFM should consider such corrective action in the best interests of the investors of the relevant AIF.
4. There should be no multiple applications of the retention requirement for any given securitisation. Net economic interest should not be subject to any credit risk mitigation or any short positions or any other hedge and should not be sold. The net economic interest should be determined by the notional value for off-balance sheet items.
5. Paragraph 1 should not apply where the securitised exposures are claims or contingent claims on or wholly, unconditionally and irrevocably guaranteed by those institutions listed in CRD Article 122a(3), and should not apply to those transactions listed in CRD Article 122a(3).

Box 35

EFAMA considers that AIFMs will in practice not be able to verify that the originator, sponsor or original lender retains a net economic interest of at least 5%. AIFMs can only check in the documentation of the securitisation product that the originator sponsor or original lender pledges to fulfil this retention requirement throughout the life of the product. Furthermore, the requirements in

Box 35 go beyond what is required under the CRD and create an unlevel playing field with other market participants.

Therefore, EFAMA considers the requirements in Box 35 too burdensome. They are likely to lead to the situation where AIFM will refrain from investments in securitisation positions.

Exemptions

Box 36

Requirements for sponsors and originator credit institutions

1. Prior to an AIFM assuming exposure to tradable securities and other financial instruments based on repackaged loans on behalf of one or more AIF, it is required that the AIFM should ensure that the sponsor, originator credit institution or original lender (as applicable):
 - Base credit granting (such as the issuance of loans or mortgages) on sound and well-defined criteria and clearly establish the process for approving, amending, renewing, and re-financing loans to the exposures to be securitized as they apply to exposures they hold;
 - Operate effective systems to manage the ongoing administration and monitoring of its various credit risk-bearing portfolios and exposures, including for identifying and managing problem loans and for making adequate value adjustments and provisions;
 - Diversify adequately each credit portfolio given its target market and overall credit strategy; and
 - Maintain documentation to include its policy for credit risk, including its risk appetite and provisioning policy and should describe how it measures, monitors and controls that risk.

Box 36

EFAMA considers that AIFMs will, in practice, not be able to ensure that the sponsors or originators fulfil the requirements mentioned in Box 36. Again, the requirements in Box 36 go beyond what is required under the CRD and create an unlevel playing field with other market participants.

Therefore, EFAMA sees the requirements in Box 36 as too burdensome and fears that they will only lead to the situation where AIFM will refrain from investments in securitisation positions.

Scope of Due Diligence Obligation

Box 37

Requirements for transparency and disclosure of retention

1. Prior to an AIFM assuming exposure to tradable securities and other financial instruments based on repackaged loans on behalf of one or more AIF, the AIFM should ensure that the sponsor, originator or original lender (as applicable) discloses to the AIFM the level of their commitment as laid down in Box 35 paragraph 1 to maintain a sufficient net economic interest in the securitization. The relevant sponsor, originator or original lender should also disclose any features of the holding that would undermine the concept of its retained interest, such as commission payments and should ensure that the AIFM has readily available access to all materially relevant data on the credit quality and performance of the individual underlying exposures, cash flows and collateral supporting and securitization exposure as well as such information that is necessary to conduct comprehensive and well informed stress tests on the cash flows and collateral values supporting the underlying exposures. For that purpose, materially relevant data should be determined as at the date of the securitisation and where appropriate due to the nature of the securitization thereafter.

Box 37

No comment

4. Appropriate requirements with respect to Article 17 (1)(b) AIFMD: qualitative requirements that must be met by AIFM

Box 38

Requirements for risk and liquidity management

1. AIFMD assuming exposure to tradable securities and other financial instruments based on repackaged loans on behalf of one or more AIF need, in order to fulfill their obligations imposed by Articles 15 and 16 AIFMD, to be able to properly identify, measure, monitor, manage, control and report the risks of these products and should pay particular attention to assessing the ALM risks, i.e. risks that arise due to mismatches between the assets and liabilities of the relevant AIF, concentration risk and investment risk arising from these products. AIFM that assume exposure to these products on behalf of one or more AIF should also particularly ensure that the risk profile of such securitization positions corresponds to the size, overall portfolio structure, investment strategies and objectives of the relevant AIF as laid down in the AIF rules or instruments of incorporation, prospectus and offering documents.

Box 38

EFAMA understands that Box 38 reflects the general principles of risk management and therefore, should be deleted or at least tied in with the proposed implementing measures for risk management in section IV.IV of the consultation paper.

Box 39

Requirements for monitoring procedures

1. AIFM should establish formal monitoring procedures in line with the principles set out in Article 15 AIFMD commensurate with the risk profile of the relevant AIF in relation to tradable securities and other financial instruments based on repackaged loans to monitor on an on-going basis and, in a timely manner, performance information on the exposures underlying such securitization positions. AIFM need to have access to relevant information to be able to perform this analysis. Such information includes (if relevant to the specific type of securitization and not limited to such types of information further described herein), the exposure type, the percentage of loans more than 30, 60 and 90 days past due, default rates, prepayment rates, loans in foreclosure, collateral type and occupancy, frequency distribution of credit scores or other measures of credit worthiness across underlying exposures, industry and geographical diversification and frequency distribution of loan to value ratios with bandwidths that facilitate adequate sensitivity analysis. Where the underlying exposures are themselves securitization positions, AIFM should have such relevant information not only on the underlying securitization tranches, such as the issuer name and credit quality, but also on the characteristics and performance of the pools underlying those securitization tranches.

Box 39

EFAMA would suggest modifying the last sentence as "Issuer name and credit quality" are no categories of securitisation tranches as implied by ESMA. If at all, these details should be deemed relevant information in relation to securitisation tranches and listed in the text above.

Box 40

Requirements for stress tests

1. Where an AIFM has assumed exposure to (on behalf of one or more AIF) a material value of tradable securities and other financial instruments based on repackaged loans, the AIFM should regularly perform stress tests according to Article 15 paragraph 3(b) AIFMD appropriate to such securitization positions simultaneously taking into account the dynamic effects of the stress test scenario on the remaining assets of the relevant AIF, i.e., the dynamic effects on such other positions that are not securitization positions (if any).

Box 40

EFAMA suggests linking the provisions in Box 40 to the general requirements for risk measurement and stress testing proposed in Box 28 in order to ensure a consistent approach to the AIF risk management.

Box 41**Requirements for formal policies, procedures and reporting**

1. Before assuming exposure to tradable securities and other financial instruments based on repackaged loans on behalf of one or more AIF, and as appropriate thereafter, an AIFM should be able to demonstrate in line with the requirements set out in Article 18 AIFMD to its competent supervisory authorities that for each of such individual securitization positions it has a comprehensive and thorough understanding of and has implemented formal policies and procedures appropriate to the investment portfolio of the relevant AIF. These formal policies and procedures should be commensurate tot the risk profile of such exposure to a securitization.
2. AIFM should also ensure in line with the requirement set out in Article 18 AIFMD that there is an adequate level of internal reporting to the senior management so that these persons are aware of any material assumption of exposure to repackaged loans and that the risks arising from the assumption of exposure to these products are adequately managed.
3. AIFM should also include appropriate information on their exposure to these products, and their risk management procedures in this area in the reports and disclosures according to Article 22 to 24 AIFMD.

Box 41

No comment

5. Grandfathering provisions**Box 42****Introduction of new underlying exposures to existing securitisations**

1. For AIFM that have assumed exposure to tradable securities and other financial instruments based on repackaged loans on behalf of one or more AIF that were issued before 1 January 2011, the above requirements should apply from 31 December 2014 where new underlying exposures are added or substituted after that date.

Box 42

EFAMA welcomes that ESMA suggest grandfathering provisions for investment in securitisation provisions. ESMA's current proposal, however, only concerns securitisation positions issued before 1 January 2011.

In addition thereto, it would be necessary to provide grandfathering provisions for investments in positions between 1 January 2011 and the entry into force of the implementing measures of the AIFMD. Without such grandfathering provisions, a highly uncertain situation exists for investments currently effected. These investments are likely not to fulfil the requirements which will eventually be applicable but are uncertain today. EFAMA considers that it would not be in the best interest of investors to require AIF invested in such non-compliant securitisation positions to immediately dispose of their holdings at the entry into force of the implementing measures of the AIFMD. EFAMA suggests that a transitional period should be granted to AIFM for dispositions of investments held by AIF at the entry into force of the new rules.

6. Article 63 AIFMD: Amendment of Directive 2009/65/EC (UCITS)

Box 43

Investments by UCITS

1. All requirements set out above should be equally applicable to UCITS assuming exposure to tradable securities and other financial instruments based on repackaged loans according to the limits of the UCITS Directive.
2. For the purpose of the transition of the requirements set out above applicable to AIFM to UCITS, any reference made above to an AIFM assuming relevant exposure on behalf of an AIF should in the case of a UCITS be construed as a reference to such management company or other person within the meaning of the UCITS Directive managing and administrating such relevant UCITS.
3. Further, for the purpose of the transition of the requirements set out above applicable to AIFM to UCITS, any reference made above to the relevant provisions of the AIFMD should be construed as a reference to such relevant legal obligations of the UCITS Directive applicable to UCITS.

Box 43

No comment.

IV.VII. Possible Implementing Measures on Organisational Requirements

General Comment

EFAMA welcomes that ESMA has aligned the implementing measures on organisational requirements to the widest extent possible with the organisational requirements under the existing UCITS and MiFID framework.

Box 44

General requirements on procedures and organisation

1. AIFM should comply with the following requirements:

- (a) To establish, implement and maintain decision-making procedures and an organizational structure which clearly and in a documented manner specifies reporting lines and allocates functions and responsibilities;
- (b) To ensure that their relevant persons are aware of the procedures which must be followed for the proper discharge of their responsibilities;
- (c) To establish, implement and maintain adequate internal control mechanisms designed to secure compliance with decisions and procedures at all levels of the AIFM
- (d) To establish, implement and maintain effective internal reporting and communication of information at all relevant levels of the AIFM as well as effective information flows with any third party involved;
- (e) To maintain adequate and orderly records of their business and internal organization.

AIFM should take into account the nature, scale and complexity of their business and the nature and range of services and activities undertaken in the course of that business.

2. AIFM should establish, implement and maintain systems and procedures that are adequate to safeguard the security, integrity and confidentiality of information, taking into account the nature of the information in question.
3. AIFM should establish, implement and maintain an adequate business continuity policy aimed at ensuring, in the case of an interruption to their systems and procedures, the preservation of essential data and functions, and the maintenance of services and activities, or, where that is not possible, the timely recovery of such data and functions and the timely resumption of their services and activities.

4. AIFM should establish, implement and maintain accounting policies and procedures that enable them, at the request of the competent authority, to deliver in a timely manner to the competent authority financial reports which reflect a true and fair view of their financial position and which comply with all applicable accounting standards and rules.
5. AIFM should monitor and, on a regular basis, evaluate the adequacy and effectiveness of their systems, internal control mechanisms and arrangements established in accordance with paragraphs 1 to 4, and to take appropriate measures to address any deficiencies.

Box 44

No comment.

Box 45**Resources**

1. AIFM should employ sufficient personnel with the skills, knowledge and expertise necessary for the discharge of the responsibilities allocated to them.
2. AIFM should ensure that the performance of multiple functions by relevant persons does not and is not likely to prevent those relevant persons from discharging any particular function soundly, honestly and professionally.
3. For the purposes laid down in paragraphs 1 and 2, AIFM should take into account the nature, scale and complexity of their business and the nature and range of services and activities undertaken in the course of that business.

Box 45

No comment.

Box 46**Electronic data processing**

1. AIFM should make appropriate arrangements for suitable electronic systems so as to permit a timely and proper recording of each portfolio transaction or subscription or, where relevant, redemption order.
2. AIFM should ensure a high level of security during the electronic data processing as well as integrity and confidentiality of the recorded information, as appropriate.

Box 46

No comment.

Box 47

Accounting procedures

1. AIFM should employ accounting policies and procedures as referred to in B.1 paragraph 4 (general requirements on procedures and organization) so as to ensure the protection of investors. AIF accounting shall be kept in such a way that all assets and liabilities of the AIF can be directly identified at all time. If an AIF has different investment compartments, separate accounts shall be maintained for those investment compartments.
2. AIFM should establish, implement and maintain accounting policies and procedures so as to ensure the calculation of the net asset value of each AIF is accurately effected on the basis of the accounting.

Box 47 Para. 2

EFAMA suggests inserting a reference to the proportionality principle (nature, scale and complexity of the business) into Box 47 Para. 2.

Box 48

Control by senior management and supervisory function

1. When allocating functions internally, AIFMD should ensure that senior management and, where appropriate, the supervisory function, are responsible for the AIFM's compliance with its obligations under the AIFM-Directive
2. The AIFM should ensure that its senior management
 - (a) Is responsible for the implementation of the general investment policy for each managed AIF, as defined, where relevant, in the fund rules, the instruments of incorporation, the prospectus or offering documents;
 - (b) Approves or oversees the approval of the investment strategies for each managed AIF;
 - (c) Is responsible for ensuring that valuation procedures according to Article 19 of the AIFM Directive are established;
 - (d) Is responsible for ensuring that the AIFM has a permanent and effective compliance function, even if this function is performed by a third party;
 - (e) Ensures and verifies on a periodic basis that the general investment policy, the investment strategies and the risk limits of each managed AIF are properly and effectively implemented and complied with, even if the risk management function is performed by third parties;
 - (f) Approves and review on a periodic basis the adequacy of the internal procedures for

- undertaking investment decisions for each managed AIF, so as to ensure that such decisions are consistent with the approved investment strategies;
- (g) Approves and reviews on a periodic basis the risk management policy and arrangements, processes and techniques for implementing that policy including the risk limit system for each managed AIF;
 - (h) Is responsible for establishing and applying a remuneration policy in line with Annex II of the AIFM-Directive
3. The AIFM should also ensure that its senior management and, where appropriate, its supervisory function should:
 - (a) Assess and periodically review the effectiveness of the policies, arrangements and procedures put in place to comply with the obligations in the AIFM-Directive;
 - (b) Take appropriate measures to address any deficiencies.
 4. AIFM should ensure that their senior management received on a frequent basis, and at least annually, written reports on matters of compliance, internal audit and risk management indicating in particular whether appropriate remedial measures have been taken in the event of any deficiencies.
 5. AIFM should ensure that their senior management receives on a regular basis reports on the implementation of investment strategies and of the internal procedures for taking investment decisions referred to in point (b) to (e) of paragraph 2.
 6. AIFM should ensure that the supervisory function, if any, receives on a regular basis written reports on the matters referred to in paragraph 4.

Box 48 Para. 2 g

Some EFAMA Members felt that the requirement of approval and review by the senior management would be too strict and suggested to also allow an approval and review by middle management.

Box 49

Permanent compliance function

1. AIFM should establish, implement and maintain adequate policies and procedures designed to detect any risk of failure by the AIFM to comply with its obligations under the AIFM-Directive, as well as the associated risks, and put in place adequate measures and procedures designed to minimize such risk and to enable the competent authorities to exercise their powers effectively under that Directive.
AIFM should take into account the nature, scale and complexity of their business, and the nature and range of services and activities undertaken in the course of that business.
2. AIFM should establish and maintain a permanent and effective compliance function which operates independently and which has the following responsibilities:
 - (a) To monitor and, on a regular basis, to assess the adequacy and effectiveness of the measures, policies and procedures put in place in accordance with paragraph 1, and the actions taken to address any deficiencies in the AIFM's compliance with its obligations;
 - (b) To advise and assist the relevant persons responsible for carrying out services and activities

to comply with the AIFM's obligation under the AIFM-Directive.

3. In order to enable the compliance function referred to in paragraph 2 to discharge its responsibilities properly and independently, AIFM shall ensure that the following conditions are satisfied:
 - (a) The compliance function must have the necessary authority, resources, expertise and access to all relevant information;
 - (b) A compliance officer must be appointed and must be responsible for the compliance function and for any reporting on a frequent basis, and at least annually, to the senior management on matters of compliance, indicating in particular whether the appropriate remedial measures have been taken in the event of any deficiencies;
 - (c) The relevant person involved in the compliance function must not be involved in the performance of services or activities they monitor;
 - (d) The method of determining the remuneration of the relevant persons involved in the compliance function must not compromise their objectivity and must not be likely to do so.

However, an AIFM shall not be required to comply with point (c) or point (d) of the first subparagraph where it is able to demonstrate that in view of the nature, scale and complexity of its business, and the nature and range of its services and activities, that requirement is not proportionate and that its compliance function continues to be effective.

Box 49 Para. 3

EFAMA appreciates that it is not required to establish an independent compliance function if this would be disproportionate for the AIFM. This clarification is however only reflected in the Explanatory Text Para. 15. EFAMA would suggest that it should be included into the text of the Box to avoid future diverging interpretation by competent authorities.

Box 50

Permanent internal audit function

1. AIFM should, where appropriate and proportionate in view of the nature, scale and complexity of their business and the nature and range of collective portfolio management activities undertaken in the course of that business, establish and maintain an internal audit function which is separate and independent from the other functions and activities of the AIFM.
2. The internal audit function referred to in paragraph 1 shall have the following responsibilities:
 - (a) To establish, implement and maintain an audit plan to examine and evaluate the adequacy and effectiveness of the AIFM's systems, internal control mechanisms and arrangements;
 - (b) To issue recommendations based on the result of work carried out in accordance with point (a);
 - (c) To verify compliance with the recommendations referred to in point (b);
 - (d) To report in relation to internal audit matters.

Box 50

Some EFAMA Members would appreciate if ESMA could include an option into the text of Box 50 to outsource the permanent internal audit function.

Box 51**Personal transactions**

1. AIFM should establish, implement and maintain adequate arrangements aimed at preventing the following activities in the case of any relevant person who is involved in activities that may give rise to a conflict of interest, or who has access to inside information within the meaning of Article 1(1) of Directive 2003/6/EC or to other confidential information relating to AIF or transactions with or for AIF by virtue of an activity carried out by him on behalf of the management company:
 - (a) Entering into a personal transaction which fulfills at least one of the following criteria:
 - (i) That person is prohibited from entering into that personal transaction within the meaning of Directive 2003/6/EC;
 - (ii) It involves the misuse or improper disclosure of confidential information;
 - (iii) It conflicts or is likely to conflict with an obligation of the AIFM under the AIFMD;
 - (b) Advising or procuring, other than in the proper course of his employment or contract for services, any other person to enter into a transaction in financial instruments or other assets which, if a personal transaction of the relevant person, would be covered by point (a) of this paragraph or by points (a) or (b) of Article 25(2) of Directive 2006/73/EC, or would otherwise constitute a misuse of information relating to pending orders;
 - (c) Disclosing, other than in the normal course of his employment or contract for services and without prejudice to Article 3(a) of Directive 2003/6/EC, any information or opinion to any other person if the relevant person knows, or reasonable ought to know, that as a result of that disclosure that other person will or would be likely to take either of the following steps:
 - (i) To enter into a transaction in financial instruments or other assets which, where a personal transaction of the relevant person would be covered by point (a) of this paragraph or by points (a) or (b) of Article 25(2) of Directive 2006/73/EC, or would otherwise constitute a misuse of information relating to pending orders;
 - (ii) To advise or procure another person to enter into such a transaction.
2. The Arrangements required under paragraph 1 shall in particular be designed to ensure that:
 - (a) Each relevant person covered by paragraph 1 is aware of the restrictions on personal transactions, and of the measures established by the AIFM in connection with personal transactions and disclosure, in accordance with paragraph 1;
 - (b) The AIFM is informed promptly of any personal transaction entered into by a relevant person covered by paragraph 1, either by notification of that transaction or by other procedures enabling the AIFM to identify such transactions;
3. Paragraphs 1 and 2 shall not apply to the following kind of personal transactions:
 - (a) Personal transactions effected under a discretionary portfolio management service where

there is no prior communication in connection with the transaction between the portfolio manager and the relevant person or other person for whose account the transaction is executed;

- (b) Personal transaction in UCITS or AIF that are subject to supervision under the law of a Member State which required an equivalent level of risk spreading in their assets, where the relevant person and any other person for whose account the transactions are effected are not involved in the management of that undertaking.

4. For the purposes of paragraphs 1, 2 and 3 of this Article, 'personal transaction' means a trade in a financial instrument or other asset effected by or on behalf of a relevant person, where at least one of the following criteria are met:
 - (a) that relevant person is acting outside the scope of the activities he carries out in that capacity;
 - (b) the trade is carried out for the account of any of the following persons:
 - (i) the relevant person;
 - (ii) any person with whom he has a family relationship, or with whom he has close links;
 - (iii) a person whose relationship with the relevant person is such that the relevant person has a direct or indirect material interest in the outcome of the trade, other than a fee or commission for the execution of the trade.

Box 51 Para. 4

Some EFAMA Members suggested that it should be clarified that this obligation only applies if the assets are relevant to the concerned AIF.

Box 52

Recording of portfolio transactions

1. AIFM should make without delay for each portfolio transaction relating to AIF a record of information which is sufficient to reconstruct the details of the order and the executed transaction or of the agreement.
2. The record referred to in paragraph 1 shall include:
 - (i) the name or other designation of the AIF and of the person acting on account of the AIF;
 - (ii) the asset;
 - (iii) where relevant, the quantity;
 - (iv) the type of the order or transaction or agreement;
 - (v) the price;
 - (vi) for orders, the date and exact time of the transmission of the order and name or other designation of the person to whom the order was transmitted, or for transactions, the date and exact time of the decision to deal and execution of the transaction; for

agreements date of signing and closing;

(vii) where applicable, the name of the person transmitting the order or executing the transaction;

(viii) where applicable, the reasons for the revocation of an order;

(ix) where relevant, for executed transactions the counterparty and execution venue identification, for agreements the contracting party.

For the purpose of point (i) of the first subparagraph, an 'execution venue' shall mean a regulated market as referred to under Article 4(1)(14) of Directive 2004/39/EC, a multilateral trading facility as referred to in Article 4(1)(15) of that Directive, a systematic internaliser as referred to in Article 4(1)(7) of that Directive, or a market maker or other liquidity provider or an entity that performs a similar function in a third country to the functions performed by any of the foregoing.

Box 52

No comment.

Box 53

Recording of subscription and redemption orders

1. AIFM should take all reasonable steps to ensure that the received AIF subscription and, where relevant, redemption orders are recorded without undue delay after receipt of any such order.
2. That record should include information on the following:
 - (a) the relevant AIF;
 - (b) the person giving or transmitting the order;
 - (c) the person receiving the order;
 - (d) the date and time of the order;
 - (e) the terms and means of payment;
 - (f) the type of the order;
 - (g) the date of execution of the order;
 - (h) the number of units or shares or equivalent amounts subscribed or redeemed;
 - (i) the subscription or, where relevant, redemption price for each unit or shares or, where relevant, the amount of capital committed and paid;
 - (j) the total subscription or redemption value of the units or shares;
 - (k) the gross value of the order including charges for subscription or net amount after charges for redemption.

Information under point (a) to (h) should be recorded without undue delay after receipt whereas information under point (i) to (k) should be recorded as soon as available.

Box 53

EFAMA understands that the recording requirements are based on the existing UCITS framework. However, it should be understood that these requirements are only applicable to the direct distribution of the AIF and that different solutions regarding the recording of orders must be permitted in case of indirect distribution or trading on a secondary market.

Box 54**Recordkeeping requirements**

1. AIFM should ensure that all required records referred to in Box 9 (portfolio transactions) and Box 10 (subscription and redemption orders) are retained for a period of at least five years unless the relevant national law provides for a longer retention period.
However, competent authorities may require AIFM to ensure that any or all of those records are retained for a longer period, determined by the nature of the asset or portfolio transaction, where it is necessary to enable the authority to exercise its supervisory functions under the AIFM-Directive.
2. Following the termination of the authorisation of an AIFM, Member States or competent authorities may require the AIFM to ensure that records referred to in paragraph 1 are retained for the outstanding term of the five-year period or the longer period required by relevant national law respectively.
Where the AIFM transfers its responsibilities in relation to the AIF to another AIFM, Member States or competent authorities may require that arrangements are made that such records are accessible to that AIFM.
3. The records shall be retained in a medium that allows the storage of information in a way accessible for future reference by the competent authority, and in such a form and manner that the following conditions are met:
 - (a) the competent authority must be able to access them readily and to reconstitute each key stage of the processing of each portfolio transaction;
 - (b) it must be possible for any corrections or other amendments, and the contents of the records prior to such corrections or amendments, to be easily ascertained;
 - (c) it must not be possible for the records to be otherwise manipulated or altered.

Box 54

EFAMA understands that the recordkeeping requirements are based on the existing UCITS framework. However, it should be understood that these requirements are only applicable to the direct distribution of the AIF and that different solutions regarding the recordkeeping of orders must be permitted in case of indirect distribution or trading on a secondary market.

Box 54 Para. 1

EFAMA suggests to add in Box 54 Para 1 “However, competent authorities may, in exceptional circumstances, require AIFM to insure ...” to achieve further alignment with the UCITS framework.

Complaints handling**Q23: Should a requirement for complaints handling be included for situations where an individual portfolio manager invests in an AIF on behalf of a retail client?**

EFAMA does not consider that a requirement for complaints handling should be included for situations where an individual portfolio manager invests in an AIF on behalf of a retail client.

The relationship between AIF and the clients is covered by MiFID provisions which ensure the existence of adequate procedures for complaints handling. Therefore, it is not required to insert any requirement into the AIFMD implementing measures.

IV.VIII. Possible Implementing Measures on Valuation

EFAMA welcomes the possible implementing measures on valuation as proposed by EFAMA. They provide for a robust framework which can be adapted to the specific characteristics of the diverse types of assets in which AIF may invest.

EFAMA appreciates that ESMA clarified a number of important points in the explanatory text. EFAMA urges ESMA to include these important clarifications into the text of the boxes in order to mitigate the danger of future diverging interpretation:

An important clarification was the point that the AIFM may appoint a number of different external valuers to one AIF in order to ensure the proper valuation of all assets.

Another very appreciated clarification was that a third party which carries out the calculation of net asset value for an AIF is not considered to be an external valuer for as long as this entity does not provide valuations for individual assets but incorporates values which are obtained from the AIFM, pricing sources or the external valuer into the calculation process.

EFAMA also appreciated the clarification that a price provider is not considered to be an external valuer.

Introduction

Box 55

Policies and procedures for the valuation of the assets of the AIF

1. AIFM should ensure that, for each AIF it manages, written policies and procedures are established, maintained and reviewed which seek to ensure a sound, transparent and appropriately documented valuation process. Without prejudice to requirements under national law, AIFM should ensure that fair, appropriate and transparent valuation methodologies are applied for the AIF they manage in accordance AIF rules and instruments of incorporation.
2. The policies shall identify and the procedures shall reflect the valuation methodologies that will be used for each of the types of assets in which the AIF may invest according to applicable national law, the AIF rules and the instruments of incorporation. The valuation methodology in respect of the specific type of asset has to be identified prior to investment in that type of asset.
3. The policies should set out the obligations, role and duties of all parties involved in the valuation process, including the senior management. The procedures should reflect the organisational structure as set out in the policies.
4. Where an external valuer is appointed, the policies and procedures should set out a process for the exchange of information between the AIFM and the external valuer to ensure that all necessary information required for the purpose of performing the valuation task are provided.
5. Where the valuation function is performed by the AIFM itself, the policies must include a description of the safeguards for functionally independent performance of the valuation task in accordance with Article 19 (4) b) of the AIFM Directive. Such safeguards should include measures to prevent or limit any person from exercising inappropriate influence over the way in which a person carries out valuation activities.

Box 55 General Comments

EFAMA understands ESMA's proposal regarding policies and procedures for the valuation of the assets of the AIF require that for each AIF a policy and procedure exists.

EFAMA understands that it is not required that for each AIF a detailed written policy and procedure be prepared. Instead the AIFM may have a written policy and procedure at the level of the AIFM. The fund rules or instruments of incorporation of individual AIFs could refer to this company-wide policy while stipulating which particular valuation procedures and methodologies should apply to the assets held by the fund.

EFAMA considers that the Explanatory Text in paragraphs 10 and 24 are essential for the proper understanding of the valuation function and would appreciate if these texts could be included into Box 55 directly.

Box 56**Models used to value assets**

1. If a model is used to value the assets, the model and its main features should be explained in the valuation policies and procedures. The reason for the choice of the model, the underlying data and assumptions used in the model and the rationale for using it should be appropriately documented.
2. AIFM should ensure before using the model that the model is validated by a person with sufficient expertise who has not been involved in the building process of the model. The model should be subject to approval by the senior management. The validation process should be appropriately documented.

Box 56 Para. 1

EFAMA understands that the use of commonly accepted pricing tools such as “Bloomberg valuation tools” are not regarded as a model in the sense of Box 56.

Box 56 Para. 2

EFAMA understands that the person validating the model may be an internal or external person.

Box 57**Consistent application of the valuation methodologies**

1. The AIFM should ensure that the policies and procedures and the designated methodologies are applied consistently.
2. The principle of consistency requires that the policies and procedures and the designated methodologies should be applied to all assets within an AIF taking into account the investment strategy, the type of assets and, if applicable, the existence of different external valuers. The policies and procedures shall be applied across all AIF having the same AIFM, taking into account investment strategies, the type of assets, time zones and, if applicable, the existence of different external valuers. Unless circumstances arise suggesting an update is required, the policies and procedures shall be applied consistent over time and valuation sources and rules shall remain consistent over time.

Box 57 Para. 2

EFAMA considers the requirements overly burdensome that policies and procedures shall be applied across all AIF having the same AIFM, and that valuation sources and rules shall remain consistent over time.

AIFM very often manage AIF incorporated in different jurisdictions which are subject to the local valuation rules and requirements. It will be difficult to create one set of policies and procedures which will comply with all of these requirements and then to apply them in a consistent manner across the entire product universe. Even if it was feasible to prepare such policies and procedures, it will not be in the interest of the investors that all funds managed by an AIFM be treated in a one size fits all approach.

EFAMA considers that Box 57 Para. 2 should be deleted. However, should Box 57 Para. 2 not be deleted, EFAMA asks ESMA to include a clarification into the text of Box 57 reflecting the idea raised in the explanatory text that the application of consistency should take into account the existence of different external valuers. It should be extended to also allow for different accounting standards and different pricing sources to be applied across different AIF's being managed.

Box 58

Periodic review of the appropriateness of the policies and procedures including the valuation methodologies

1. The policies should allow for a review of the policies and procedures, including the valuation methodologies, periodically. The review should be carried out at least annually and prior to the engagement of the AIF with a new investment strategy or a new type of asset that is not covered by the actual valuation policy.
2. The policies should outline how a change to the valuation policy, including a methodology can be effected and in what circumstances this is appropriate. Recommendations for changes to the policies shall be made to the senior management which should review and approve any changes.
3. The Risk Management Function referred to in Box 25 should review and, if needed, provide appropriate support concerning the policies and procedures adopted for the valuation of assets.

Box 58

No comment.

Box 59

Review of individual values

1. The AIFM should ensure that the values of all assets held by the AIF are fair and appropriate. The AIFM has to document his assessment of the appropriateness and fairness of the individual values. The AIFM must be able to demonstrate that the AIF portfolios have been properly valued.
2. The policies and procedures should set out a review process for the individual value of assets, where applicable to the type of asset, if the material risk of an inappropriate valuation exists. The policies and procedures should describe the review process including sufficient and

appropriate checks on the reasonableness of such values.

3. The valuation policies and procedures should include appropriate escalation measures to address differences on the valuation of assets.

Box 59

EFAMA considers that the requirements in Box 59 to Review of individual values are overly burdensome. In particular, if an external valuer has been appointed, the AIFM should be allowed to rely on the values provided by the valuer. This is also in line with the text of the Directive which is clear and does, in EFAMA's opinion, not require further interpretation.

Box 59 Para. 1

EFAMA disagrees with the very strict and burdensome requirements posed on the AIFMD in Box 59 Para. 1. In case of an appointment of an external valuer, it should be sufficient that the AIFM ensures that there are procedures in place at the level of the external valuer for appropriate and fair valuation of the assets. The AIFM has to be able to rely on a delegate which meets the requirements of having sufficient resources, being of sufficiently good reputation and being sufficiently experienced, without having to duplicate part of the work.

EFAMA suggests modifying the first sentence and deleting the second and third sentence of paragraph 1.

Box 59 Para. 2 and 3

EFAMA considers that the requirements in Box 59 Para. 2 and 3 are too burdensome. If an external valuer has been appointed, the AIFM should be allowed to rely on the values provided by the valuer. Furthermore, the reference to "material risk" is too vague and will leave too much room for diverging interpretation by the different competent authorities.

EFAMA strongly suggests that Box 59 Para. 2 and 3 be deleted.

Box 60

Calculation of net asset value per unit or share

1. The AIFM should ensure that the net asset value is calculated on the occasion of each issue or subscription of units or shares but at least once a year.
2. The AIFM should ensure that the procedures and the methodology for calculating the net asset value per unit or share is fully documented. The documentation and its application should be subject to regular verification by the AIFM.
3. The AIFM should ensure that remediate procedures are in place in the event of an incorrect calculation of the net asset value.

4. The AIFM should ensure that the number of units or shares in issue is subject to regular verification at least as often as the unit or share price is calculated.

Box 60 General Comment

EFAMA welcomes ESMA's clarification in the Explanatory Text Para. 24 that a third party which calculates the NAV on the basis of values obtained from other sources shall not be considered external valuer.

Some EFAMA Members suggested an amendment of the Explanatory Text Para. 24. They suggested that the difference between the valuer and an administrative agent calculating the NAV (without being the valuer) consists in the fact that the valuer determines the values. In this opinion, it is the essential feature of the valuers activity that the valuer determines the valuations. In other words, persons merely calculating the NAV without determining the valuation are not to be considered valuers.

In order to reflect this idea more clearly, EFAMA suggests amending para. 24 as follows:

"A third party which carries out the calculation of the net asset value for an AIF is not considered to be an external valuer for the purposes of Article 19 of the Directive, so long as this entity does not determine final valuations for individual assets (...)."

Furthermore, in order to avoid a different interpretation by competent authorities in the future, EFAMA suggests that this clarification should be included directly into the text of Box 60.

EFAMA also invites ESMA to reformulate the Explanatory Text paragraph 23 stating *'the AIFM is always responsible for ... where appropriate the appointment of an external valuer.'* EFAMA considers that this imposes a requirement going beyond the requirements in the Level 1 text and does not allow for sufficient flexibility. Article 19 (7) of the AIFM only states that the AIFM shall notify the appointment of an external valuer to the competent authorities. Article 19 does not state that the AIFM must appoint the valuer. The appointment could also be made by the governing body of an AIF that has appointed an external AIFM and also has the power to appoint an external valuer. EFAMA suggests that the Explanatory Text para. 23 should be amended accordingly.

3. Types of professional guarantees

Box 61

Professional guarantees

1. Professional guarantees to be furnished by the external valuer have to be written documents signed by the valuer or its legal representatives.
2. The professional guarantees should contain the evidence of the external valuer's qualification

and capability to perform the valuation; this includes evidence of

- a) sufficient personnel and technical resources
- b) adequate procedures safeguarding proper and independent valuation and
- c) adequate knowledge and understanding

in respect to the investment strategy of the AIF and the assets the external valuer is appointed to value.

3. In case the external valuer is authorised to carry out valuation services by the competent authority of the state where it is established, the professional guarantee should contain the name of this authority including the relevant contact information.

Box 61

No comment.

4. Frequency of valuation carried out by open-ended funds

Box 62

Frequency of valuation carried out by open-ended funds

1. The valuation of assets that are financial instruments has to take place every time the net asset value per unit or share has to be calculated pursuant to Box 60 paragraph 1.
2. The valuation of other assets has to take place at least once a year, unless there is evidence that the last determined value is no longer fair and/or proper.

Box 62

No comment.

IV.IX. Possible Implementing Measures on Delegation

General Comments

EFAMA welcomes that the ESMA proposals regarding implementing measures for the AIFMD are to a large extent aligned with the existing MiFID and UCITS requirements.

The proposed possible implementing measures regarding delegation, however, go beyond the existing requirements and EFAMA would appreciate if ESMA could review its proposals to achieve a better alignment. For example, the requirements with regard to the good repute of the delegate in

Box 66 go beyond MiFID and UCITS requirements and seem overly prescriptive. Furthermore, the requirements in relation to conflicts of interest in a delegation framework are more detailed than under the MiFID and UCITS frameworks and will be difficult to fulfill while complying with confidentiality obligations and data protection rules.

Box 63

Delegation

1. The AIFM must comply with the provisions of Article 20 of the AIFMD prior to a third party performing a task which would otherwise be undertaken by the AIFM and which is critical or important for the proper performance of the functions it provides to an AIF.
2. A function or task shall be regarded as critical or important if a defect or failure in its performance would materially impair the continuing compliance of the AIFM with the conditions and obligations of its authorisation or its other obligations under the AIFMD, or its financial performance or the soundness or continuity of the functions it performs.
3. Without prejudice to the status of any other function or task the following functions shall not be considered as critical or important for the purposes of paragraph 1 and 2;
 - (a) the provision to the firm of advisory services, and other services which do not form part of the functions which the AIFM may additionally provide in the course of the collective management of an AIF, including the provision of legal advice to the AIFM, the training of personnel of the AIFM, billing services and the security of the firm's premises and personnel;
 - (b) the purchase of standardised services, including market information services and the provision of price feeds.

Box 63

EFAMA welcomes the proposals by ESMA in Box 63. The Explanatory Text Para. 9 and 11 are considered crucial for the understanding of the proposals in Box 63, in particular the term of "critical and important functions". EFAMA urges ESMA to include the clarifications of Explanatory Text Para. 9 and 11 directly into Box 63.

Box 64

General principles

1. Where an AIFM delegates to third parties the task of carrying out on its behalf one or more of its functions, the AIFM should comply, in particular, with all of the following conditions:
 - (a) the delegation should not result in the delegation of senior management's responsibility;
 - (b) the obligations of the AIFM towards its investors under the AIFMD should not be altered due to the delegation;

- (c) the conditions with which the AIFM must comply in order to be authorized in accordance with the AIFMD, and to remain so, should not be undermined;
 - (d) the AIFM should ensure that the delegate carries out the delegated functions effectively and in compliance with applicable laws and regulatory requirements and must establish methods for reviewing the services provided by each delegate on an ongoing basis. The AIFM should take appropriate action if it appears that the delegate may not be carrying out the functions effectively or not in compliance with applicable laws and regulatory requirements;
 - (e) the AIFM should retain the necessary expertise and resources to supervise the delegated tasks effectively and manage the risks associated with the delegation. The AIFM should also ensure that the delegate properly supervises the carrying out of the delegated functions, and adequately manages the risks associated with the delegation
 - (f) the AIFM should ensure that continuity and quality of the delegated tasks are guaranteed also in case of a termination of delegation by either transferring the delegated tasks to another third party or incorporating it into the AIFM;
 - (g) the respective rights and obligations of the AIFM and the delegate should be clearly allocated and set out in a written agreement. In particular, the AIFM must contractually ensure its instruction and termination rights. The agreement should make sure that sub-delegation could take place only with the AIFM's consent;
 - (h) whenever the portfolio management is delegated, the delegation must be in accordance with the investment policy of the AIF. The delegate should be instructed by the AIFM how to implement the investment policy and the AIFM should monitor whether the delegate complies with it on an ongoing basis.
2. The AIFM should in particular take the necessary steps to ensure that the following conditions are satisfied:
- (a) the delegate must disclose to the AIFM any development that may have a material impact on its ability to carry out the delegated functions effectively and in compliance with applicable laws and regulatory requirements;
 - (b) the delegate must protect any confidential information relating to the AIFM the AIF affected by the delegation and the investors of these AIF;
 - (c) the delegate must establish, implement and maintain a contingency plan for disaster recovery and periodic testing of backup facilities while taking into account the types of delegated functions.

Box 64

EFAMA welcomes that the proposed implementing measures in Box 64 regarding General Principles are based on the current UCITS and MiFID framework. However, EFAMA considers that the proposals as currently drafted much stricter than the UCITS and MiFID regimes and would suggest amendments.

Box 64 Para. 1

ESMA's proposal provides that in case of a delegation by the AIFM to third parties, the AIM should comply, in particular, with the conditions mentioned in Box 64.

EFAMA would appreciate if the conditions for delegation were harmonised on a European Level. Therefore, EFAMA suggests that the words "in particular" should be deleted from Box 64 Para. 1.

Furthermore, EFAMA considers that full compliance with all conditions at any time is not realistic. The relevant provisions in the MiFID framework take this into account. EFAMA asks ESMA to modify the wording of Box 64 Para. 1 in order to align it more closely with the MiFID framework. It should only require the AIFM to take necessary steps to ensure that the conditions are met.

Box 64 para. 1 f

EFAMA understands that the requirement in Box 64 para. 1f should be interpreted to mean that the AIFM shall make provisions to ensure continuity and quality of delegated tasks in cases of a termination of delegation. Our understanding is that the AIFM will have to ensure that only in case a termination of delegation is planned, the transfer of the delegated tasks to another third party or the insourcing of the function within the AIFM is properly managed to ensure continuity and quality of the delegated task.

Box 65**Objective Reasons**Option 1

The AIFM must be able to justify its entire delegation structure with objective reasons; to comply with this the AIFM should be able to demonstrate that the delegation is done for the purpose of a more efficient conduct of the AIFM's management of the AIF.

Option 2

Objective reasons for delegating tasks include but are not limited to:

- optimising of business functions and processes;
- cost saving;
- expertise of the delegate in administration/ specific markets/ investments;
- access of the delegate to global trading capabilities.

Q24: Do you prefer Option 1 or Option 2 in Box 65? Please provide reasons for your view.

A very large majority of EFAMA Members prefer Option 1. They prefer Option 1 because it provides a general rule which can be applied in a flexible manner to a multitude of different cases. They also mentioned that Option 1 is more consistent with the approach under the UCITS framework. Option 2 is considered too prescriptive and could possibly be interpreted by the competent authorities as an exhaustive, limitative list.

Some EFAMA Members considered that Options 1 and 2 could be combined. Option 2 could be combined with Option 1 as an indicative, non-exhaustive list of rationales to qualify as objective reasons for delegation of tasks under Option 1.

Box 66**Sufficient resources and experience and sufficiently good repute of the delegate**

1. The AIFM has to evaluate if the delegate has sufficient resources to perform the delegated tasks and if the persons who effectively conduct the business of the delegate are sufficiently experienced and of sufficiently good repute.
2. The delegate should be considered to have sufficient resources if it employs sufficient personnel with the skill, knowledge and expertise necessary for the discharge of the tasks delegated to it and the appropriate organizational structure for the delegated tasks.
3. The persons who effectively conduct the business of the delegate should be considered to have sufficient experience if they have appropriate theoretical knowledge and appropriate practical experience in the relevant functions.
4. The persons who effectively conduct the business of the delegate should be considered to have sufficiently good repute if there are at least no negative records relevant both for the assessment of a good repute and for the proper performance of the delegated tasks. Such negative records include relevant criminal offences, judicial proceedings or administrative sanctions.

Box 66

EFAMA disagrees with the very detailed and burdensome requirements in Box 66. These requirements go far beyond what is required under the UCITS framework. EFAMA asks for a closer alignment between the approach taken under the AIFMD with the UCITS framework.

EFAMA also considers that in case of a delegation of tasks by the AIFM to one of the entities listed in Box 67, requirements under Box 66 para. 2-4 shall be deemed to be fulfilled. EFAMA asks ESMA to include this explicitly into the text of Box 66.

For all other cases of delegation, the requirements of Box 66 para. 2-4 should be modified. In particular the conditions in Box 66 para. 4 will in practice be difficult to assess as in some countries such negative records are not made public or at least are not public until a final verdict. Furthermore,

the requirement as currently drafted is not subject to the proportionality principle. However, it will not be practical for firms to carry out independent checks as to criminal records with regard to all employees of a delegate.

EFAMA suggests that regarding the evaluation of a delegate's good reputation in accordance with the proposed para. 4, AIFM should be allowed to rely upon a formal confirmation by the delegate concerning the absence of negative records relevant for the proper performance of the delegated tasks.

Box 67

Types of institution that should be considered to be authorised or registered for asset management and subject to supervision

(1)

- Management companies authorized under the UCITS Directive,
- investment firms authorised under the MiFID Directive to perform portfolio management,
- credit institutions authorised under the Directive 2006/48/EC having the authorisation to perform portfolio management under MiFID, and
- externally-appointed AIFM authorised under the AIFM Directive

should be assumed as authorised for the purpose of asset management and subject to supervision.

Box 67

A very large majority of EFAMA Members welcome the ESMA proposal in Box 67 regarding the types of institution that should be considered to be authorised and registered for asset management and subject to supervision.

One EFAMA Member considers that authorising management companies to delegate to credit institutions could lead to regulatory arbitrage. This EFAMA Member believes that delegation should be allowed to entities authorised for investment management.

Box 68

A delegation would prevent the effective supervision of the AIFM, or the AIFM from acting, or the AIF from being managed, in the best interest of its investors in particular under the following circumstances:

1. A delegation would prevent the effective supervision of the AIFM where the AIFM does not take the necessary steps to ensure that the following conditions are satisfied:
 - (a) the AIFM, its auditors and the relevant competent authorities must have effective access to data related to the delegated functions, as well as to the business premises of the delegate;

- and the competent authorities must be able to exercise those rights of access;
- (b) the delegate must cooperate with the competent authorities of the AIFM in connection with the delegated functions.
 - (c) the AIFM makes available on request to the competent authority all information necessary to enable the authority to supervise the compliance of the performance of the delegated functions with the requirements of Article 20 of the AIFMD.
2. A delegation would prevent the AIFM from acting, or the AIF from being managed, in the best interests of its investors where the interests of the delegate may conflict with those of the AIFM or the investors of the AIF unless the potential conflicts of interest are properly identified, managed and monitored.

Box 68

No comment.

Box 69**Sub-delegation – General principles**

The conditions set out in Boxes 63-68 should apply mutatis mutandis where the delegate sub-delegates any of its functions to a sub-delegate.

Box 69

No comment.

Box 70**Type of evidence necessary for an AIFM to demonstrate its consent to sub-delegation**

AIFM should demonstrate its consent to each sub-delegation in writing.

Box 70 General Comment

EFAMA agrees with the proposal in Box 70.

Box 71

Criteria to be taken into account when considering whether a delegation/ sub-delegation would result in a material conflict of interest with the AIFM or the investors of the AIF; and for ensuring that portfolio or risk management tasks haven been functionally and hierarchically separated from any other potentially conflicting tasks within the delegate/ sub-delegate; and that potential conflicts of interest are properly identified, managed, monitored and disclosed to the investors of

the AIF

1. Criteria whether a delegation/ sub-delegation would result in a material conflict of interest with the AIFM or the investors of the AIF:
 - (a) Where the AIFM and the sub-delegate are members of the same group or have any other contractual relationship, it should be taken into account the extent to which the sub-delegate controls the AIFM or has the ability to influence its actions;
 - (b) Where the AIFM is aware that the sub-delegate and an investor of the relevant AIF are members of the same group or have any other contractual relationship, it should be considered the extent to which this investor controls the sub-delegate or has the ability to influence its actions.
2. The portfolio or risk management tasks should be considered as functionally and hierarchical separated from other potentially conflicting tasks where the following conditions are satisfied:
 - (a) Those engaged in portfolio management tasks are not engaged in the performance of potentially conflicting tasks such as controlling tasks;
 - (b) Those engaged in risk management tasks are not engaged in the performance of potentially conflicting tasks such as operating tasks;
 - (c) Those engaged in risk management tasks are not supervised by those responsible for the performance of the operating tasks;
 - (d) The separation is ensured up to the governing body of the delegate/subdelegate.
The functional and hierarchical separation of portfolio or risk management tasks from any other potentially conflicting tasks within the delegate/ sub-delegate should be calibrated to the nature, scale and complexity of the delegate/ sub-delegate's business and to the nature and range of activities undertaken in the course of that business.
3. Criteria whether potential conflicts are properly identified, managed, monitored and disclosed to the investors of the AIF:

The delegate/ sub-delegate should take all reasonable steps to identify, manage and monitor conflicts of interest that may arise between the delegate/ sub-delegate and the AIFM or the investors of the AIF. The delegate/ sub-delegate should disclose potential conflicts of interest as well as the procedures and measures to be adopted by it in order to manage such conflicts to the AIFM which should disclose them to the investors of the relevant AIF.

Box 71 General Comment

EFAMA welcomes the approach taken by ESMA regarding the proposals in Box 71. EFAMA appreciates in particular that ESMA applies the proportionality principle regarding the separation of functions.

Box 71 Para. 2a

EFAMA understands that the requirement of independence in Box 71 Para. 2a refers to the independence between the portfolio management function and the risk management function. EFAMA encourages ESMA to modify the wording in Box 71 para. 2a to reflect this more clearly.

Box 72

Form and content of notification under Article 20(4)(b) of the AIFMD

The notification should contain details of the delegate and the sub-delegate, name of the competent authority (in case the sub-delegate is authorized or registered), delegated tasks, AIF affected by the sub-delegation, copy of written consent by the AIFM and the intended effective date of the delegation.

Box 72

No comment.

Box 73

Letter-box entity

The AIFM would become a letter-box entity and could no longer be considered to be the manager of the AIF where:

1. the AIFM no longer retains the necessary expertise and resources to supervise the delegated tasks effectively and manage the risks associated with the delegation; or
2. the AIFM no longer has the power to take decisions in key areas which fall under the responsibility of the senior management or no longer has the power to perform senior management functions in particular in relation to implementation of the general investment policy and investment strategies.

Box 73

EFAMA welcomes ESMA's proposal in Box 73 as it will provide a robust framework while giving the AIFM flexibility regarding their management structures.

V. Depositaries

V.I. Appointment of a depositary

1 Contract evidencing the appointment of a depositary

1.1 Particulars of the contract appointing the depositary

Box 74

Particulars to be included in the written agreement evidencing the appointment of a single depositary and regulating the flow of information deemed necessary to allow the depositary to perform its functions pursuant to Article 21 (2) of the AIFMD.

The depositary on the one hand and the AIFM and / or the AIF on the other hand shall draw up a written agreement setting out the rights and obligations of the parties to the contract.

This agreement should include at least the following elements:

1. A description of the services to be provided by the depositary and the procedures to be adopted for each type of asset in which the AIF may invest and which may be entrusted to the depositary;
2. A description of the types of assets that will fall within the scope of the depositary's function which should be consistent with the information provided in the AIF rules, instruments of incorporation and offering documents, regarding the assets in which the AIF may invest;
3. A statement that the depositary's liability shall not be affected by any delegation of its custody functions unless it has discharged itself of its liability in accordance with the requirements of Article 21 (13) or (14); and where applicable, the conditions under which the AIF or the AIFM may allow the depositary to transfer its liability to a sub-custodian including the objective reasons that could support that transfer;
4. The period of validity, and the conditions for amendment and termination of the contract; and, if applicable, the procedures by which the depositary should send all relevant information to its successor;
5. The confidentiality obligations applicable to the parties in accordance with prevailing laws and regulations; these obligations should not impair the ability of Member States competent authorities to have access to the relevant documents and information;
6. The means and procedures by which the depositary will transmit to the AIFM or the AIF all relevant information that the latter needs to perform its duties including the exercise of any rights attached to assets, and in order to allow the AIFM and the AIF to have a timely and accurate situation of the accounts of the AIF. The details of such means and procedures should be described in this agreement or set out in the service level agreement or similar document;
7. The means and procedures by which the AIFM will ensure the depositary has access to all the information it needs to fulfil its duties, including the process by which the depositary will receive information from other parties appointed by the AIF or the AIFM;
8. Information regarding the possibility for the depositary or a sub-custodian to re-use the assets it

- was entrusted with or not and where relevant the conditions related to the potential re-use;
9. The procedures to be followed when a modification to the AIF rules, instruments of incorporation or offering documents is being considered, detailing the situations in which the depositary should be informed, or where a prior agreement from the depositary is needed to proceed with the modification;
 10. All necessary information that needs to be exchanged between the AIF, the AIFM and the depositary related to the sale, subscription, redemption, issue, cancellation and re-purchase of units or shares of the AIF;
 11. Where the parties to the contract envisage appointing third parties to carry out their respective duties, an undertaking to provide, on a regular basis, details of any third parties appointed; and upon request, information on the criteria used to select the third party and the steps taken to monitor the activities carried out by the selected third party;
 12. All information regarding the tasks and responsibilities in respect of obligations relating to anti-money laundering and combating the financing of terrorism;
 13. Information on all cash accounts opened in the name of the AIF or in the name of the AIFM on behalf of the AIF and procedures by which the depositary will be informed prior to the effective opening of any new account opened in the name of the AIF or in the name of the AIFM on behalf of the AIF;
 14. Details regarding the depositary's escalation procedure(s), including the identification of the persons to be contacted within the AIF and / or the AIFM by the depositary when it launches such a procedure.

Subject to national law, there shall be no obligation to enter into a specific written agreement for each AIF; it shall be possible for the AIFM and the depositary to enter into a framework agreement listing the AIF managed by that AIFM to which it applies.

The parties may agree to transmit part or all of this information electronically. Proper recording of such information shall be ensured.

The agreement shall include the procedures by which the depositary, in respect of its duties has the ability to enquire into the conduct of the AIFM and / or the AIF and to assess the quality of information transmitted including by way of on-site visits. It shall also include a provision regarding the possibilities and procedures for the review of the depositary by the AIFM and / or the AIF in respect of the depositary's contractual obligations.

The law applicable to the agreement shall be specified.

Box 74

EFAMA welcomes the approach suggested by ESMA consisting in defining the particulars to be included in the depositary agreement by reference to the corresponding requirements under the existing UCITS legal framework, subject to a limited number of adaptations to take into account the specificities of AIF's (in particular, the fact that they are authorised to invest in a wider range of assets) and the additional requirements contained in the Level 1 AIFM Directive. A large majority of

EFAMA members also welcome the fact that the list of particulars contained in Box 74 is explicitly presented as non exhaustive. This will preserve the level of flexibility required to allow the parties to adapt the contents of the agreement to their particular needs (depending, for instance, on the type of AIF and its legal structure, the type of assets to be safe kept, the applicable law, ...).

Concerning the particulars to be included in the agreement, EFAMA would recommend the following clarifications:

- For the avoidance of any doubt, EFAMA recommends to amend item 2 in Box 74 so as to read “A description of the type of assets that will fall within the scope of the depositary’s **safekeeping and oversight** functions (...)”.
- The description of the type of assets under item 2 should also include a description of the geographic zones in which the AIF/AIFM plans to invest as this is an essential information to allow the depositary to fulfil its obligations (such as, for instance, the duty to properly assess and monitor relevant custody risks as defined in Box 80, item 1 (c)).
- EFAMA also considers that the list of particulars to be included in the agreement should also include an undertaking by the depositary to notify the AIFM when it becomes aware that the segregation of assets is not (or no longer) sufficient to ensure protection from insolvency of a sub-custodian in a specific jurisdiction (please also refer to our answer to question 46 below).
- EFAMA specifically supports item 11 relating to the provision of details of any third party appointed but considers that this undertaking needs to be extended to deal with further delegations so that the full custody chain is disclosed.
- Under item 12, the requirement to provide “**all** information (...)” is not sufficiently specific and should be replaced by a requirement to provide “*(Relevant) Information regarding the tasks and responsibilities in respect of obligations relating to anti-money laundering and combating the financing of terrorism*” (same wording as for items 8 and 13).

Although EFAMA considers that the list of particulars contained in Box 74 is appropriate (subject to the above required clarifications), one should recognize that the challenge for the AIFs/AIFMs and their depositaries will reside in the level of details required by some of the elements to be included in the contract (description of procedures ...). With this in mind, EFAMA strongly supports the confirmation by ESMA that there shall be no obligation to enter into a separate agreement for each AIF and that it will be possible to enter into framework agreements covering several AIFs managed by the same AIFM. This will significantly reduce the administrative burden (and associated costs) that the drafting, signature and regular maintenance/updating of these agreements represent for the parties without any negative impact on the level of investors’ protection.

In the same line, the reference made by ESMA to the fact that the depositary agreement may be supplemented by a service level agreement (SLA) or a similar document is also very important in practice. Some of the particulars listed in Box 74 (for instance, the descriptions of procedures

required under items 1, 6, 7, 9, 13 and 14) are indeed too detailed to fit appropriately in the depositary agreement itself. They are also inevitably subject to much more frequent changes than other elements of the agreement. In this context, EFAMA would strongly welcome a clarification by ESMA that the use of a SLA (or similar document) is not restricted to the description of the means and procedures referred to in Box 74, item 6 but can also be used for the description of other procedures and information listed in Box 74, as and when the parties to the agreement deem appropriate (a narrow interpretation of item 6 in Box 74 could indeed lead to a different conclusion, which, we assume, was probably not the aim of ESMA's draft advice and would considerably reduce the practical use of SLA's), thus allowing the AIFM and the depositary the ability to determine the need for a SLA and whether such descriptions and procedures should be included in the depositary agreement or SLA.

Finally, EFAMA fully agrees with the justifications given by ESMA for not providing a model agreement (page 142 of the Consultation Paper).

V.III. Depositary functions

1 Depositary functions pursuant to §7 – Cash monitoring

1.1 Cash flow monitoring

Box 75

Cash Monitoring – general information requirements

The AIFM should ensure the depositary is provided, upon commencement of its duties and on an ongoing basis, with all relevant information it needs to comply with its obligations pursuant to Article 21 (7) including by third parties and particularly that:

- the depositary is informed, upon its appointment, of all existing cash accounts opened in the name of the AIF, or in the name of the AIFM acting on behalf of the AIF;
- the depositary is informed prior to the effective opening of any new cash account by the AIF or the AIFM acting on behalf of the AIF;
- the depositary is provided with all information related to the cash accounts opened at a third party entity, directly from those third parties in order for the depositary to have access to all information regarding the AIF's cash accounts and have a clear overview of all the AIF's cash flows.

Where the depositary does not receive this information, the AIFM will have been deemed not to have satisfied the requirements of Article 21 of the directive.

Box 75

EFAMA broadly agrees with the general information requirements proposed by ESMA, subject to the following remarks:

- Second bullet point: it ought to be clarified that the obligation to inform the depositary prior to the opening of new cash accounts does not imply that the depositary has any influence in the choice of the counterparties where the accounts are opened. Indeed, this is purely an investment decision for which the AIFM is the only responsible.
- Third bullet point: this requirement to provide "... all information related to cash account ..." is drafted in very broad terms and appears to be too extensive, given that the regulatory purpose (as described in paragraph 4 of explanatory text) is only to enable timely access by the depositary to the cash account. In line with the introductory paragraph in Box 75, the wording should therefore be amended to read as follows: "the depositary is provided with **the necessary (or relevant)** information related to the cash accounts opened at a third party entity, directly from those third parties in order for the depositary to have access to the information regarding the AIF's cash accounts **it needs to comply with its obligations** and have a clear overview of all the AIF's cash flows".

Additionally, the last sentence in Box 75 following which "*where the depositary does not receive this information, the AIFM will have been deemed no to have satisfied the requirements of Article 21 of the Directive*" is problematic for several reasons:

1° it seems to impose an obligation of result on the AIFM even though there may be situations where the information could not be provided to the depositary for reasons beyond the AIFM's control;

2° the reference to "the requirements of Article 21 of the Directive" without any further specification is, in our opinion, much too broad.

3° the practical/legal implications of the AIFM's failure to ensure that the depositary receives all the information it needs are therefore unclear.

EFAMA therefore recommends withdrawing that last sentence in Box 75 as it creates a number of legal uncertainties without bringing any added value or clarification to the AIFM's information obligations already clearly described in Box 75. Alternatively, if ESMA believes that this sentence should be maintained, it should at least (1) clarify that the AIFM is not under an obligation of results but under an obligation of means to provide that information and (2) narrow the reference to "the requirements of Article 21 of the Directive" to a failure to meet the requirements of Article 21.7 of the Directive which specifically deals with the cash monitoring obligation. ESMA should also clarify the implications of the AIFM's failure to provide the depositary with the relevant information (which, in our opinion, should not lead to an automatic and unconditional discharge of the depositary's duty to perform its cash monitoring functions, although with persistent and unjustified failure ultimately this could be the result).

Box 76**Proper monitoring of all AIF's cash flows****Option 1**

The depositary should act as a central hub to ensure an effective and proper monitoring of all cash movements and in particular, it should:

1. ensure the cash belonging to the AIF is booked in an account opened at the depositary; or
2. where cash accounts are opened at a third party entity:
 - (a) ensure those accounts are only opened with entities referred to in Article 18 (1) (a) to (c) of Directive 2006/73/EC or another entity of the same nature in the relevant market where cash accounts are required as defined in §2 of Box 77 (Ensuring the AIF's cash is properly booked)
 - (b) mirror the transactions of those cash accounts into a position keeping system and make periodic reconciliations between the cash accounts statements and the information stemming from the AIF's accounting records
 - (c) ensure the AIFM has taken appropriate measures to send all instructions simultaneously to the third party and the depositary

Option 2

To ensure the AIF's cash flows are properly monitored, the depositary should at least:

1. ensure that cash accounts opened at a third party are only opened with entities referred to in Article 18 (1) (a) to (c) of Directive 2006/73/EC or another entity of the same nature in the relevant market where cash accounts are required as defined in §2 of Box 77 (Ensuring the AIF's cash is properly booked);
2. ensure there are proper procedures to reconcile all cash flow movements and verify that they are performed at an appropriate interval;
3. ensure appropriate procedures are implemented to identify on a timely basis significant cash flows and in particular those which could be inconsistent with the AIF's operations;
4. review periodically the adequacy of those procedures including through a full review of the reconciliation process at least once a year;
5. monitor on an ongoing basis the outcomes and actions taken as a result of those procedures and alert the AIFM if an anomaly has not been rectified without undue delay.

Box 76

EFAMA has a clear preference for option 2 (please also refer to our answers to questions 29 to 31 below).

EFAMA would also welcome further guidance from ESMA as to what should be understood with “significant cash flows” (Box 76, item 3).

1.3 Conditions for ensuring the AIF's cash is properly booked

Box 77

Ensuring the AIF's cash is properly booked

The depositary should be required to:

1. ensure that the AIFM complies on an ongoing basis with the requirements of Article 16 of Directive 2006/73/EC in relation to cash and in particular where cash accounts are opened at a third party entity in the name of the depositary acting on behalf of the AIF, take the necessary steps to ensure the AIF's cash is booked in one or more cash accounts distinct from the accounts where the cash belonging to the depositary or belonging to the third party are booked
2. ensure the AIF's cash is booked in one or more cash accounts opened at an entity referred to in Article 18 (1) (a) to (c) of Directive 2006/73/EC or at a bank or a credit institution of the non EU country in which the AIFM / AIF has been compelled to open a cash account in relation to an investment decision

Box 77

EFAMA considers the requirement of Box 77 to be adequate and reasonable.

Q25: How difficult would it be to comply with a requirement by which the general operating account and the subscription / redemption account would have to be opened at the depositary? Would that be feasible?

First of all, EFAMA remarks that the Level 1 Directive explicitly retains the possibility that cash accounts (be they for general operating or subscription/redemption purposes) be opened with third parties. We therefore clearly question the compatibility with the Level 1 text of Level 2 measures which would impose that cash accounts be opened only with the depositary (we note in this context that ESMA recognises that this would consist in a “restrictive interpretation of the AIFMD text” – see Consultation Paper, cost-benefit analysis, p. 310-311).

It should also be noted that, in many cases, such requirement would not conform to the current market practice (e.g. for Real Estate funds) and it would be onerous to make the required changes to current practices and procedures with little perceived benefit accruing to investors. The same effect could be achieved by requiring the depositary to ensure that appropriate checks and controls are in place at the Transfer agent and that proper recordkeeping and reconciliation procedures are established and working effectively.

Furthermore, it is clear that the requirement that subscriptions and redemption prices settle on a depositary account is likely to reinforce to a certain extent the integrity of the issuance and redemption of shares/units by easing up and making safer the depositary's monitoring of settlement process. However, it is equally clear that the advantages of such requirement would be offset by a number of significant disadvantages including, in particular, a damaging impact on distribution channels (as pointed out by ESMA, see Consultation Paper, p. 310) as well as potentially increased costs.

Finally, it should be noted that not all depositaries either have the regulatory or operational capability to operate such accounts. Even if operated within the depositary group, such accounts are often operated by another group entity. There are also cases where an AIFM has multiple funds with different depositaries. Such managers may have only one pooled subscription/redemption account covering a number of AIFs with a credit institution. It would be operationally complex if managers were to be required to open subscription/redemption accounts at each individual depositary.

Q26: At what frequency is the reconciliation of cash flows performed in practice? Is there a distinction to be made depending on the type of assets in which the AIF invests?

It is very difficult to provide a general answer to that question, given that the frequency of cash reconciliations may significantly vary from one fund to another, depending on a variety of factors.

In practice, open-ended AIFs trading on a daily basis will often be subject to a daily reconciliation of cash flows for subscriptions and redemptions, whereas for operating accounts reconciliation is in general performed on a monthly or quarterly (ex-post) basis. However, there is no general rule and the frequency of reconciliations may vary significantly from one AIF to another.

Furthermore, the frequency of the reconciliation usually does not essentially depend on the type of assets in which the AIF invests but will rather be influenced by the valuation frequency of the fund (reconciliation frequency should – at least – match the calculation frequency) and/or take into account the impact of cash collateral arrangements. It will also be dependent on the number and activity of cash accounts opened with entities other than the depositary.

Q27: Are there any practical problems with the requirement to refer to Article 18 of MiFID?

EFAMA does not anticipate any practical problem with this requirement.

Q28: Does the advice present any particular difficulty regarding accounts opened at prime brokers?

Provided option 2 in Box 76 is retained, EFAMA has not identified any particular difficulties regarding accounts opened at prime brokers. In practice, sufficient reporting is usually received from prime brokers to enable timely cash reconciliations to be reviewed by the depositary on a periodic basis.

It may, however, be worth mentioning in this context that the depositary will be relying on the prime broker or AIFM to provide sufficient documentation to demonstrate that it fulfils the requirement of Box 77, item 2 to *“ensure the AIF’s cash is booked in one or more accounts opened at an entity referred to in Article 18(1) (a) to (c) of Directive 2006/73/EC or at a bank or credit institution of the non EU country in which the AIFM/AIF has been compelled to open a cash account in relation to an investment decision”* as the depositary will not have access to that information.

Q29: Do you prefer option 1 or option 2 in Box 76? Please provide reasons for your view.

EFAMA has a clear preference for option 2.

Indeed, the requirements described under option 1 and, in particular, the requirement to mirror the transactions into a position-keeping system would be very expensive to implement and would also be a pure duplication of the work already performed by fund administrators, without tangible added value in terms of investors’ protection.

We also wish to draw the attention to the fact that the allusion made by ESMA (Consultation Paper, item 9 in Explanatory text on page 150) to a weekly verification by the depositary for funds performing reconciliations on a daily basis would not conform to market practice. For the sake of clarity, we therefore recommend to withdraw this example and to leave it to the depositary to decide on a case by case basis on the appropriate periodicity for the performance of its monitoring duties.

Q30: What would be the estimated costs related to the implementation of option 1 or option 2 of Box 76? / Q31: What would be the estimated costs related to the implementation of cash mirroring as required under option 1 of Box 76?

Given the very diverse nature of the funds covered by the AIFMD, it is nearly impossible to quantify these costs and, even if we were in a position to provide average figures, their reliability would be so unrepresentative that they might lead to wrong conclusions.

Nevertheless, it seems fairly safe to assume that Option 1 would lead to significantly higher costs than Option 2 as it would undoubtedly involve employing more people to perform the tasks, in particular mirroring the transactions of those cash accounts into a position keeping system and making periodic reconciliations between the cash accounts and the AIF’s accounting records.

2.1 Definition of the financial instruments that should be held in custody

Box 78

Definition of financial instruments to be held in custody – Article 21 (8) (a)

Pursuant to Article 21 (8) (a), financial instruments belonging to the AIF should be included in the scope of the depositary's custody function when they meet all the criteria defined below:

1. they are transferable securities, money market instruments or units of collective investment undertakings – as listed in Annex I, section C of Directive 2004/39/EC;
2. they are not provided as collateral in accordance with the provisions set out in Box 79; and

Option 1

3. they are registered or held in an account directly or indirectly in the name of the depositary.

Option 2

3. they are financial instruments with respect to which the depositary may itself or through its sub-custodian instruct the transfer of title or an interest therein by means of a book-entry on a register maintained by a settlement system as designated by Directive 98/26/EC or a similar non-European securities settlement system which acts directly for the issuer or its agent.

Additionally, financial instruments which can be physically delivered to the depositary should be held in custody.

Financial instruments that are directly registered with the issuer itself or its agent (e.g. a registrar or a transfer agent) in the name of the AIF should not be held in custody unless they can be physically delivered to the depositary. Further, financial instruments which comply with the definition set out above will remain in custody when the depositary is entitled to re-use them whether that right has been exercised or not. Where the financial instruments have been provided by the AIF or the AIFM acting on behalf of the AIF to a third party under a temporary lending agreement, they will no longer be held in custody by the depositary and fall under the definition of 'other assets' in accordance with Article 21 (8) (b).

In the context of Option 1, where the financial instruments are registered directly with the issuer or its agent making the depositary the only registered owner on behalf of one or more unidentified clients, the financial instruments should be held in custody. However, such financial instruments should not be held in custody if the depositary is clearly identified in the register as acting on behalf of the AIF and thus the AIF is clearly identified as the owner of the financial instruments.

All financial instruments that do not comply with the above definition should be considered as 'other assets' under the meaning of the AIFMD Article 21 (8) (b) and be subject to record keeping duties.

Box 78

A large majority of EFAMA members agree with ESMA's proposed advice that the type of financial instruments that can be registered in a financial instruments account opened in the name of the AIF

in the depositary's books, which should be included in the scope of the depositary custody duties as referred to in point (a) of Article 21.7, should be limited to transferable securities, units in collective investment undertakings and money market instruments, as set out in sub-paragraphs (1) to (3) of Annex I Section C of Directive 2004/39/EC.

EFAMA also agrees with the principle set out in item 2 of Box 78 on collateral (with the understanding that it only applies to the collateral posted by the AIF, as opposed to collateral received by the AIF) and with the fact that any financial instrument that can be physically delivered to the depositary is to be considered as being "held in custody".

EFAMA also believes that ESMA has appropriately addressed the issue of instruments registered with an issuer or an agent of the issuer in Box 78 paragraph 3, which should not be regarded as being held "in custody". It is correct to limit this to instances where the financial instruments that are directly registered with the issuer or agent in the name of the AIF.

There are however different opinions within the membership of EFAMA as to the most appropriate choice concerning both options set out by ESMA in Box 78, item 3 (please refer to our answer to Question 32 below).

Q32: Do you prefer option 1 or option 2 in Box 78? Please provide reasons for your view.

A number of EFAMA members hold the view that both options presented by ESMA in Box 78 do not seem fully appropriate as they would actually narrow the scope of the depositary provisions in a way that goes beyond the intention of the Level 1 text.

Indeed, they consider that the custody status of an instrument cannot be linked to the possibility of its transfer via a settlement system subject to certain criteria (in particular, in view of the fact that in many non-EU markets adequate settlement systems do not exist due to the absence of a central depository) as contemplated under Option 2.

At the same time, they also consider that Option 1 would need to be amended for the following reasons:

- At the level of the depositary, financial instruments are recorded in the depositary books in the name of the AIF. Directly below in the custody chain, financial instruments must be registered as belonging to clients of the depositary according to paragraph 1 (a) of Box 89 in order to distinguish assets safe-kept for the depositary on behalf of its clients from the depositary's own assets (e.g. "Depositary XYZ Omnibus Client Account"). If a further sub-custodian is appointed, financial instruments must be once again registered with that sub-custodian as belonging to clients of the global custodian (e.g. "Global Custodian XYZ omnibus client account"). Thus, any appointment of a sub-custodian would bring the assets outside the ambit of Option 1 which is inconsistent as the appointment takes place precisely for

custody reasons. In this context, the meaning of the word “indirectly” registered or held is also unclear.

- Moreover, disclosure of acting on behalf of a fund is generally deemed necessary for evidence reasons.
- Option 1 also leaves it open to the depositary to structure the manner in which it holds the financial instruments so as to circumvent the provisions of the Directive.

In order to address those shortcomings, these members propose to amend the wording of Option 1 in such a manner that the decisive criterion would be the substantive power of disposal or claim vested with the depositary in respect of the registered account or held assets. Under this proposal, item 3 in Box 78 would read as such: ***“they are financial instruments with respect to which the depositary has the right of disposal/can effectuate the transfer of title or interest and/or has the right to claim these financial instruments”***.

Other EFAMA members have a clear preference for Option 2 for the reasons stated by ESMA in the Consultation Paper and because the fact that the securities are registered in a regulated settlement system (CSDs and ICSDs) provides for the conditions necessary for the shares to be considered “held in custody”. These conditions include providing for certainty of transfer of ownership arising from “delivery versus payment/receipt versus payment” (“DVP/RVP”) on settlement of the relevant transaction, which the custodian effectively controls via its participant account at CSD/ICSD (either directly or indirectly via the sub-custodian). This in turn provides assurance as to when customers (such as AIFs) become entitled to ownership of the relevant securities. They argue that if Option 1 was retained, where a depositary is acting as “nominee” for a client in a register it is likely that the depositary would be liable for any loss of that asset as it is held “indirectly” by the depositary. They see this as problematic as the choice of the registrar is fundamentally that of the issuer and the depositary has no control over their function. In their opinion, a depositary is not entitled to ensure the adequacy of procedures of registrars, even where it wishes to do so, and the depositary cannot ensure the asset is non-transferable.

Lastly, EFAMA believes that, notwithstanding the particulars of the definition of financial instruments to be held in custody, the depositary should be under an obligation to inform the AIF and/or the AIFM of any assets belonging to the AIF for which it does not assume the custody function, according to the applicable legal criteria.

Q33: Under current market practice, which kinds of financial instrument are held in custody (according to current interpretations of this notion) in the various Member States?

Question not answered.

Box 79**Treatment of collateral – Article 21 (8) (a)**

Financial instruments provided as collateral should not be held in custody if they are provided:

Option 1

under a title transfer financial collateral arrangement as defined in Directive 2002/47/EC on financial collateral arrangements

Option 2

under a title transfer financial collateral arrangement or under a security financial collateral arrangement by which the control over / possession of the financial instruments within the meaning of Article 2 (2) of Directive 2002/47/EC on financial collateral arrangements is transferred away from the AIF or the depositary to the collateral taker or a person acting on its behalf

Option 3

under a financial collateral arrangement as defined in Directive 2002/47/EC on financial collateral arrangements

Box 79

A large majority of EFAMA members considers that Option 3 is the most appropriate because it has the widest scope. Indeed, Option 3 makes it clear that, notwithstanding the type of financial collateral agreement, the collateral that is transferred out of the depositary's books falls outside of the scope of the custody obligations (as the collateral would no longer be under its 'control') and therefore should be considered to be part of the category 'other assets' (and, as such, subject to the safekeeping duties as set out in Box 81). In that context, we are not sure to understand the purpose of the distinction being made under option 2 between "title transfer financial collateral arrangement" and "security financial collateral arrangement".

It should also be noted that Directive 2002/47/EC on financial collateral arrangements will have to be amended so that an AIF and an AIFM fall within the scope of Article 1.2 as already is the case for UCITS and UCITS management companies.

Further, we note that the draft advice does not explicitly deal with collateral received by the depositary or any sub-custodian for the benefit of the AIF. We are of the view that any financial instruments received as collateral should be regarded as having been "entrusted to the depositary for safe-keeping" within the meaning of Art. 21(8) AIFMD.

Q34: How easy is it in practice to differentiate the types of collateral defined in the Collateral Directive (title transfer / security transfer)? Is there a need for further clarification of option 2 in Box 79?

In practice it will not always be easy to differentiate between a “title transfer collateral arrangement” and a “security financial collateral arrangement” as the agreement setting out the collateral arrangement is often very complex and would require an indepth legal analysis to determine to which category the collateral arrangement belongs. However, as already mentioned in our comments to Box 79 we do not see the relevance of the distinction being made under option 2 between both types of collateral arrangements

2.2 Conditions applicable to the depositary when performing its safekeeping duties on each category of assets

Box 80

Safekeeping duties related to financial instruments that can be held in custody

1. To comply with its obligations pursuant to Article 21 (8) (a), the depositary should be required to at least:
 - (a) Ensure the financial instruments are properly registered in segregated accounts in order to be identified at all times as belonging to the AIF
 - (b) Exercise due care in relation to the financial instruments held in custody to ensure a high level of protection
 - (c) Assess and monitor all relevant custody risks. In particular, depositaries should be required to assess the custody risks related to settlement systems and inform the AIFM of any material risk identified.
2. Where the depositary has delegated its custody functions, the depositary would remain subject to the requirements of §1 (c) and would further have to ensure the third party (hereafter referred to as the ‘sub-custodian’²³) complies with §1 (b) as well as with the segregation obligations set out in Box 16.

Box 80

EFAMA agrees with the general principles and the description of the safekeeping duties related to financial instruments that can be held in custody proposed by ESMA under Box 80.

For the sake of clarity, item 2 in Box 80 should be modified to oblige the depositary to impose on its delegate that any further delegation will also be on the basis of the segregation requirements set out in Box 89.

Furthermore, it should be clarified that the disclosure requirement under item 1(c) should apply to all custody risks and not only to custody risks related to settlement systems. It should also apply to the entire custody chain (as partly addressed under item 2 of Box 80). In our comment on Box 88, EFAMA also makes suggestions as to how paragraph 1(b) of this Box 80 might be clarified as regards what “due care” means in relation to a custody chain. Please read this Box in conjunction with Box 88.

Box 81

Safekeeping duties related to ‘other assets’ – Ownership verification and record keeping

The AIFM should ensure the depositary is provided, upon commencement of its duties and on an ongoing basis, with all relevant information it needs to comply with its obligations pursuant to Article 21 (8) (b) including by third parties.

To comply with its obligations pursuant to Article 21 (8) (b), the depositary should be required to at least:

1. Ensure it has timely access to all relevant information it needs to perform its ownership verification and record keeping duties, including from third parties (e.g. prime brokers).
2. Ensure that it possesses sufficient and reliable information for it to be satisfied of the AIF's ownership right or of the ownership right of the AIFM acting on behalf of the AIF over the assets.
3. Maintain a record of those assets for which it is satisfied the AIF or the AIFM acting on behalf of the AIF holds the ownership of those assets.

In order to comply with that obligation, the depositary should be required to:

- (a) register, on behalf of the AIF, assets in its name or in the name of its delegate; or
- (b) ensure, where assets are registered directly in the name of the AIF or the AIFM, or physically held by the AIF or the AIFM, it is able to provide at any time a comprehensive and up to date inventory of the AIF's assets.

To that end, the depositary should:

Option 1

- (i) ensure there are procedures in place so that assets so registered cannot be assigned, transferred, exchanged or delivered without the depositary or its delegate having been informed of such transactions; or
- (ii) have access to documentary evidence of each transaction from the relevant third party on a timely basis

Option 2

mirror all transactions in a position keeping record

In the context of § (b) the AIFM should be required to ensure that the relevant third party provides the depositary with certificates or other documentary evidence every time there is a sale / acquisition or a corporate action and at least once a year.

In any event, the depositary should ensure that the AIFM has and implements appropriate procedures to verify that the assets acquired by the AIF it manages are appropriately registered in the name of the AIF or in the name of the AIFM on behalf of the AIF, and to check consistency between the positions in its records and the assets for which the depositary is satisfied the AIF or the AIFM acting on behalf of the AIF holds the ownership.

Additional requirement if Option 2 is retained in Box 78 with regard to the definition of financial instruments to be held in custody

In the context of § (a), the depositary should ensure the AIF, its investors or the AIFM acting on behalf of the AIF, are able to exercise their rights if a problem arises that affects assets for which the depositary or its delegate is the registered owner either by clearly identifying the AIF as the ultimate owner of the assets or, where the depositary or its delegate is the only registered owner of the assets on behalf of a group of one or more unidentified clients, by taking appropriate actions to ensure the AIF's ownership right is recognised by the relevant parties. Where a legal action is required, the costs related to such an action would have to be borne by the AIF, the AIFM or as the case may be the AIF investors.

4. The depositary should set up and implement an escalation process for situations where an anomaly is detected (e.g. to notify the AIFM and if the situation cannot be clarified / corrected, alert the competent authority).

Box 81

EFAMA has a clear preference for Option 1 in Box 81, given that the benefits of a full mirroring exercise are questionable and that the costs of Option 2 would be very significant and would impose unwarranted additional costs on the depositary (and, therefore, on the AIF's investors) without commensurate benefits in terms of investors' protection. Option 1 is also closer to the current market practice.

Concerning the wording of Option 1, EFAMA recommends changing item 2 from "the relevant third party" to "a relevant third party" in order to allow the depositary to rely on documentary evidence provided by another third party than its delegate.

EFAMA agrees that it is beneficial to require documentary evidence upon every acquisition or sale of a significant asset and upon every significant corporate action. This requirement should however be proportionate and should be required only for assets which have a significant impact on the investment portfolio (e.g. ancillary assets in a real estate property would not be material in this regard). Furthermore, it is not common practice to renew legal real estate title or corporate

certification on an annual basis, as such documentation is not always easily attainable and may require legal counsels to carry out further investigations. Instead, we would favour a risk-based approach to such documentation whereby the depositary would focus primarily on significant transactions and proceed with refreshes of existing documentation where appropriate.

Q35: How do you see the delegation of safekeeping duties other than custody tasks operating in practice?

See comments on Box 81 above.

Q36: Could you elaborate on the differences notably in terms of control by the depositary when the assets are registered directly with an issuer or a registrar (i) in the name of the AIF directly, (ii) in the name of the depositary on behalf of the AIF and (iii) in the name of the depositary on behalf of a group of unidentified clients?

There is no significant difference in terms of control when assets are registered in any of the formats outlined in the question. The key control is focused on the parties that can instruct the movement of the assets and/or has the right to claim the assets.

Q37: To what extent would it be possible / desirable to require prime brokers to provide daily reports as requested under the current FSA rules?

It is both possible and desirable that prime brokers provide daily reporting on the status of their client assets and client money. This information should be available online for depositaries to access as required. In practice, UK based prime brokers are currently obliged to provide this information and it would be beneficial to have this standard of reporting in place for all prime brokers contracted to provide prime broker services to AIFs.

Q38: What would be the estimated costs related to the implementation of option 1 or option 2 of Box 81? Please provide an estimate of the costs and benefits related to the requirement for the depositary to mirror all transactions in a position keeping record?

It is impossible to quantify these costs with precision given the very diverse nature of funds covered by the AIFMD.

However, as already mentioned above, it is safe to assume that the costs of Option 2 (full mirroring of all transactions) would be considerably higher than the costs of Option 1.

Q39: To what extent does / should the depositary look at underlying assets to verify ownership over the assets?

EFAMA believes that in order to fulfil its duty to verify the ownership of the assets of the AIF and to adequately protect the interests of AIF investors, the depositary should be required to apply a “look-through approach” to the entire AIF’s asset structure, i.e. that the depositary must look through any intermediary entity controlled (directly or indirectly) by the AIF which is interposed between the AIF and its target investments. **This requirement should however be applied with a sense of proportionality.** In this context, depositaries should, for instance, be able to rely on appropriate documentary evidence and legal opinions as well as on accredited auditors with local expertise to satisfy themselves that the appropriate documentation is in place to demonstrate that the AIF or the AIFM acting on behalf of the AIF holds the ownership of those assets. Such requirement is obviously of particular relevance for AIFs which are making substantial use of intermediary entities, such as AIFs investing in real estate through an SPV, private equity and other multi layered structures such as fund of funds or master-feeder funds.

EFAMA recommends that confirmation of this requirement be given by Level 2 implementing measures in order to enhance the level playing field sought by the Level 1 text in relation to the scope of the depositary functions.

3 Depositary functions pursuant to §9 – Oversight duties

Box 82

Oversight duties – general requirements

At the time of its appointment, the depositary should assess the risks associated with the nature, scale and complexity of the AIF’s strategy and the AIFM’s organisation in order to define oversight procedures which are proportionate to the AIF and the assets in which it invests. Such procedures should be regularly updated.

To comply with its oversight duties, the depositary is expected to perform *ex post* controls and verifications of processes and procedures that are under the responsibility of the AIFM, the AIF or an appointed third party. The depositary should in all circumstances ensure a procedure exists, is appropriate, implemented and frequently reviewed.

The depositary is required to establish a clear and comprehensive escalation procedure to deal with situations where potential irregularities are detected in the course of its oversight duties, the details of which should be made available to the competent authorities upon request.

The AIFM should ensure the depositary is provided, upon commencement of its duties and on an ongoing basis, with all relevant information it needs to comply with its obligations pursuant to Article 21 (9) including by third parties and particularly that the depositary is able to perform on-site visits of its own premises and any service provider appointed by the AIF or the AIFM (e.g.

Administrator, external valuer) to ensure the adequacy and relevance of the procedures in place.

Box 82

EFAMA agrees with the general requirements regarding oversight duties described in Box 82 and welcomes the confirmation that the oversight duties of the depositary essentially consist in ex post controls and involve a verification of the appropriateness of the procedures and processes put in place by the AIF/AIFM rather than in a duplication of tasks or controls already performed by other entities.

(a) Oversight duties related to subscriptions / redemptions

Box 83

Clarifications of the depositary's oversight duties

Duties related to subscriptions / redemptions (a)

To fulfil its duties pursuant to Article 21 (9) (a), the depositary should be required to:

1. ensure that the AIF, the AIFM or the designated entity has and implements an appropriate procedure to :
 - (a) reconcile
 - the subscription / redemption orders with the subscription proceeds / redemptions paid, and
 - the number of units or shares issued / cancelled with the subscription proceeds received / redemptions paid by the AIF
 - (b) verify on a regular basis that the reconciliation procedure is appropriate.
To that end, the depositary should in particular regularly check the consistency between the total number of units or shares in the AIF's accounts and the total number of outstanding shares or units that appear in the AIF's register
2. ensure and regularly check the compliance of the procedures regarding the sale, issue, repurchase, redemption and cancellation of shares or units of the AIF with the applicable national law and the AIF rules and / or instruments of incorporation and verify that these procedures are effectively implemented.

The frequency of the depositary's checks should be proportionate to the frequency of subscription and redemptions.

Box 83

Please refer to our answer to question 43 below.

(b) Oversight duties related to the valuation of shares or units of the AIF

Box 84

Clarifications of the depositary's oversight duties

Duties related to the valuation of shares / units (b)

1. The depositary should verify on an-going basis that appropriate and consistent procedures are established for the valuation of the assets of the AIF in compliance with the requirements of Article 19 and its implementing measures and the AIF rules and instruments of incorporation.
2. The depositary should ensure that the valuation policies and procedures are effectively implemented and periodically reviewed.
3. The depositary's procedures should be proportionate to the nature, scale and complexity of the AIF and conducted at a frequency consistent with the frequency of the AIF's valuation policy as defined in Article 19 and its implementing measures.
4. Where the depositary considers the calculation of the value of the shares or units of the AIF has not been performed in compliance with applicable law or the AIF rules or the provisions of Article 19, it should notify the AIFM and ensure timely remedial action has been taken in the best interest of the AIF's investors.
5. Where applicable, the depositary should be required to check that an external valuer has been appointed in accordance with the provisions of Article 19 of the AIFMD and its implementing measures.

Box 84

EFAMA considers that Box 84 and its explanatory text are imposing more duties on the depositaries than foreseen by Art. 21.9(b) which requires that the depositary "(...) ensure that **the value of the units or shares of the AIF are calculated** in accordance with the applicable national law, the AIF rules of incorporation and the procedures laid down in Article 19 (...)". This does not require the depositary to directly oversee the valuation of assets. Similarly, it should not be the depositary's duty to check that an external valuer has been appointed as it is the responsibility of the AIFM and it goes beyond the requirements of the Level 1 text. Consequently, EFAMA recommends to delete items 1 and 5 in Box 84 and to amend items 2 and 3 as follows:

2. "The depositary should ensure that the policies and procedures **for the calculation of the value of the units or shares of the AIF** are effectively implemented and periodically reviewed".
3. "of the AIF's valuation policy as defined in Article 19 and its implementing measures" should be replaced with "**for the calculation of the value of the units or shares of the AIF**".

(c) Oversight duties relating to the carrying out of the AIFM's instructions**Box 85****Clarifications of the depositary's oversight duties****Duties related to the carrying out of the AIFM's instructions (c)**

To fulfil its obligation pursuant to Article 21 (9) (c), the depositary should be required to:

1. Set up and implement appropriate procedures to verify the compliance of the AIF / AIFM with applicable law and regulation as well as with the AIF's rules and instruments of incorporation. In particular, the depositary should monitor compliance of the AIF with investment restrictions and leverage limits defined in the AIF's offering documents. Those procedures should be proportionate to the nature, scale and complexity of the AIF.
2. Set up and implement an escalation procedure where the AIF has breached one of the limits or restrictions referred to under §1.

Box 85

Please refer to our answer to question 44 below.

Box 86**Clarifications of the depositary's oversight duties****Duties related to the timely settlement of transactions (d)****Option 1**

No additional requirement

Option 2

To fulfill its obligation pursuant to Article 21(9)(d), the depositary should be required to set up a procedure to detect any situation where the consideration is not remitted to the AIF within the usual time limits, notify the AIFM and where the situation has not been remedied, request the restitution of the financial instruments from the counterparty where possible.

Where the transactions do not take place on a regulated market, the usual time limits should be assessed with regard to the conditions attached to the transactions (OTC derivative contracts, investments in real estate assets or in privately held companies)

Box 86

Please refer to our answer to question 45 below.

(e) Oversight duties relating to the AIF's income distribution

Box 87

Clarifications of the depositary's oversight duties

Duties related to the AIF's income distribution (e)

To fulfil its obligation pursuant to Article 21(9)(e), the depositary should be required to:

1. Ensure the net income calculation is applied in accordance with the AIF rules, instruments of incorporation and applicable national law
2. Ensure appropriate measures are taken where the AIF's auditors have expressed reserves on the annual financial statements
3. Check the completeness and accuracy of dividend payments and where relevant of the carried interest

Box 87

EFAMA considers that some of the requirements of Box 87, as they are currently worded, go beyond the Level 1 text or are not in line with the general oversight requirements as set out in Box 82:

- Concerning item 1, the depositary oversight duty should consist in ensuring that appropriate procedures are in place to ensure that the net income calculation is applied in accordance with the AIF rules, instruments of incorporation and applicable national law. The same applies to item 3.
- Concerning item 2, EFAMA holds the view that it is not the depositary's role to ensure that the reserves expressed by the auditors are effectively and appropriately followed up by the AIF or the AIFM.

Q40: To what extent do you expect the advice on oversight will impact the depositary's relationship with funds, managers and their service providers? Is there a need for additional clarity in that regard?

EFAMA welcomes the principle-based implementing measures proposed by ESMA with respect to oversight duties, which will be instrumental in achieving an appropriate harmonization of duties across all European Member States. By and large, the proposed advice on the depositary's oversight

duties seems to achieve the right balance between flexibility, the harmonization objectives and the costs related to the implementation and ongoing monitoring duties.

In defining the precise contents and boundaries of the depositary control duties, ESMA should however take particular care to make sure that those duties remain proportional to the respective functions and duties of other service providers involved (such as transfer agents, fund administrators or auditors). In this context, please refer to our specific comments to Boxes 84, 85 and 87 above.

If the right balance is achieved, EFAMA believes that the proposed advice will not materially impact the relationship between the depositary, the AIF/AIFM and the other service providers. To the contrary, it will enhance the cooperation and the flow of information among those entities, to the benefit of an increased investors' protection.

Q41: Could potential conflicts of interest arise when the depositary is designated to issue shares of the AIF?

There may indeed be situations where a conflict of interest could arise when the legal entity acting as depositary is also in charge of issuing the shares of the AIF, because of the depositary duty of oversight in relation to the subscription and redemption of shares. Such situations should be addressed by ensuring that there are adequate procedures in place to segregate both functionally and hierarchically the functions of depositary and transfer agents (Chinese walls).

Q42: As regards the requirement for the depositary to ensure the sale, issue, repurchase, redemption and cancellation of shares or units of the AIF is compliant with the applicable national law and the AIF rules and / or instruments of incorporation, what is the current practice with respect to the reconciliation of subscription orders with subscription proceeds?

In certain jurisdictions, this is completed by undertaking a number of oversight functions on the transfer agent which may include onsite inspections focusing on reviews of processes and controls, and sample testing of shareholder activity.

Q43: Regarding the requirement set out in §2 of Box 83 corresponding to Article 21 (9) (a) and the assumption that the requirement may extend beyond the sales of units or shares by the AIF or the AIFM, how could industry practitioners meet that obligation?

We understand that this question actually refers to the sales of units of the AIF on a secondary market. EFAMA is of the opinion that, considering the set up of distribution networks in Europe, it would be practically impossible for the depositary to fulfill that obligation. Consequently, we believe that the oversight duty of the depositary should be limited to the verification of information stemming from the AIF's register. This is in line with ESMA's working assumption, which EFAMA strongly supports, that "the depositary is not required to make verifications along the distribution

channel but rather to put the focus on the entity which centralizes the subscriptions (e.g. a transfer agent) and limit the verification to the information stemming from the AIF's register" (Consultation Paper, item 11, p. 151).

For the avoidance of doubt about the scope of depositary duties, EFAMA strongly recommends that this clarification be explicitly mentioned in Box 83.

Q44: With regards to the depositary's duties related to the carrying out of the AIFM's instructions, do you consider the scope of the duties set out in paragraph 1 of Box 85 to be appropriate? Please provide reasons for your view.

EFAMA considers that the scope of the duties as described in Box 85 is appropriate and in line with current market practice.

However, EFAMA recommends adapting the wording of item 1 in Box 85 as follows, in order to align it on the requirements of Article 21.9(c) of the AIFMD that explicitly refers to the applicable national law: *"Set up and implement appropriate procedures to verify the compliance of AIF/AIFM with **the** applicable **national** law and regulation (...)"*.

Q45: Do you prefer option 1 or option 2 in Box 86? Please give reasons for your view.

A large majority of EFAMA members have a clear preference for Option 1. Indeed, they are of the opinion that the Level 1 requirement to ensure the settlement of transactions within the usual time limits is sufficiently clear and that there is no evidence that additional requirements would be necessary. They do not believe that the additional requirements proposed by ESMA under Option 2 would bring any significant clarification in this respect.

Section 2 Due diligence duties

Box 88

Due Diligence Requirements

1. When the depositary delegates any of its safekeeping functions, it should implement an appropriate, documented and regularly reviewed due diligence process in the selection and ongoing monitoring of the delegate.
 - (a) When appointing a sub-custodian, the depositary should roll out a due diligence process which aims to ensure that entrusting financial instruments to a sub-custodian provides an adequate level of protection. Such a process should include at least the following steps:
 - (i) assess the regulatory and legal framework (including country risk, custody risk,

- enforceability of contractual agreements). This assessment should particularly enable the depositary to determine the potential implication of the insolvency of the sub-custodian
- (ii) assess whether the sub-custodian's practice, procedures and internal controls are adequate to ensure the financial instruments will be subject to reasonable care
 - (iii) assess whether the sub-custodian's financial strength and renown are consistent with the delegated tasks. This assessment shall be based on information provided by the potential sub-custodian as well as third party data and information where available
 - (iv) ensure the sub-custodian has the operational and technological capabilities to perform the delegated custody tasks with a satisfactory degree of protection and security
- (b) The depositary should perform ongoing monitoring to ensure the sub-custodian continues to comply with the criteria defined under §1 and the conditions laid out in Article 21 (11) (d), and at least:
- (i) monitor the sub-custodian's performance and its compliance with the depositary's standards
 - (ii) ensure it exercises reasonable care, prudence and diligence in the performance of its custody tasks and particularly that it effectively segregates the financial instruments assets in line with the requirements set out in Box 16
 - (iii) review the custody risks associated with the decision to entrust the assets to that entity and promptly notify the AIF or AIFM of any change in these risks. This assessment should be based on information provided by the sub-custodian as well as third party data and information where available. During market turmoil or where a risk has been identified, the frequency and the scope of the review should be increased
2. The depositary should design contingency plans for each market in which it appoints a delegate to perform safekeeping duties. Such a contingency plan may include the identification of an alternative provider, if any.
3. The depositary shall terminate the contract in the best interest of the AIF and its investors where the delegate no longer complies with the requirements.

Box 88

EFAMA agrees with the due-diligence requirements as set out in Box 88.

We welcome the choice made by ESMA in favor of a principle based approach rather than a template and a list of due diligence tasks to perform. This will indeed give the depositary the required flexibility to adapt its due diligences to the specific circumstances of each delegation scenario and will also avoid a "tick-the-box" exercise which would be detrimental to the protection of the investors.

However, for the avoidance of any doubt, it should be made clear that in case of a sub-delegation by a sub-custodian of its custody functions, the due-diligence requirements described in Box 88 apply *mutatis mutandis* to the relevant parties in the custody chain (as foreseen for the segregating requirements under Box 89, item 3).

As a corollary principle (and with the same objective to mitigate the risks resulting from the creation of custody chains), many EFAMA members would strongly welcome a clarification by ESMA that in Box 80 under item 1(b) "due care" would involve the depositary – as lead custodian to whom assets are entrusted for safekeeping- undertaking four key oversight duties. The depositary would be obliged:

- To know which custodians constitute the custody chain;
- To understand the relevant risks that exist at each level of the chain;
- To ensure that the due-diligence and segregation obligations have been imposed throughout the chain (from delegate to delegate) at a contractual level;
- To ensure that it has appropriate right of access to the books and records of the sub-custodian as well as any of its delegates to ensure compliance with these requirements; and
- To document all the above, make these documents available and report to the AIFM

The end result should be that the depositary should ensure that the level of protection relating to AIF's assets is not diluted by subsequent sub-delegations.

Section 3 Segregation

Box 89

Segregation obligation for third parties to which depositaries have delegated part or all of their safekeeping functions (based on Article 16 of Directive 2006/73/EC implementing the MiFID Directive)

1. Where safekeeping functions have been delegated partly or totally to a third party, the depositary must ensure that the third party acts in accordance with the segregation obligation pursuant to Article 21 (11) (d) (iii) by verifying that the third party has put in place arrangements that are compliant with the following requirements:
 - (a) to keep such records and accounts as are necessary to enable it at any time and without delay to distinguish assets safekept for the depositary on behalf of its clients from its own assets and from assets held for any other client (including assets belonging to the depositary itself);
 - (b) to maintain records and accounts in a way that ensures their accuracy, and in particular their correspondence to the assets safekept for the depositary's clients;
 - (c) to conduct, on a regular basis, reconciliations between its internal accounts and records and those of any sub-delegate by whom those assets are safekept;
 - (d) to take the necessary steps to ensure that any financial instruments belonging to the

depository's clients entrusted to a sub-delegate are identifiable separately from the financial instruments belonging to the sub-delegate, by means of differently titled accounts on the books of the sub-delegate or other equivalent measures that achieve the same level of protection;

- (e) to take the necessary steps to ensure that cash belonging to the depository's clients deposited in a central bank, a credit institution or a bank authorised in a third country is held in an account or accounts identified separately from any accounts used to hold cash belonging to the third party or where relevant the sub-delegate.

2. Where the depository has delegated its custody functions, monitoring the sub-custodian's compliance with its segregation obligations should ensure the financial instruments belonging to its clients are protected from the event of insolvency of that sub-custodian. If, for reasons of the applicable law, including in particular the law relating to property or insolvency, the requirements described in §1 are not sufficient to reach that objective, the depository should assess what additional arrangements could be made in order to minimise the risk of loss and maintain an adequate level of protection.
3. The requirements in §1 and §2 should apply mutatis mutandis when the third party has decided to delegate part or all of its tasks to a sub-delegate as foreseen in Article 21 (11).

Box 89

EFAMA considers that the segregation requirements described in Box 89 appear to be adequate and reasonable.

However, EFAMA would welcome a clarification from ESMA concerning the practical implications of explanatory note (5) (page 176 of the Consultation Paper) that seeks to widen the scope of the segregation duty to assets in 'recordkeeping'. Article 21.11(d)(iii) AIFMD is referring to assets belonging to the depository's clients for the safekeeping of which the depository wants to appoint a third party. This paragraph stipulates that the depository needs to ensure that its (clients) assets are properly segregated by the appointed third party. This requirement apparently implies that the depository is part of the custody chain, hence excluding 'record keeping' assets (indeed, for record keeping assets, the third parties would not be appointed by the depository), so it is hard to see how the level 1 text that specifically focuses on delegation by the depository can be expanded through level 2 implementing measures to require the depository to ensure segregation at a third party not appointed by it.

Q46: What alternative or additional measures to segregation could be put in place to ensure the assets are 'insolvency-proof' when the effects of segregation requirements which would be imposed pursuant to this advice are not recognised in a specific market? What specific safeguards do depositaries currently put in place when holding assets in jurisdictions that do not recognise effects of segregation?

In markets where the effects of the segregation requirements outlined in box 89 are not recognized, the typical issue is that there is no acceptance of the 'nominee' concept, whereby the account holder or legal owner is not necessarily the real or beneficial owner of the securities, but may be holding securities on behalf of its clients. As a result, those countries consider an intermediary in the chain of safekeeping as the real or beneficial owner, with adverse consequences in case of the intermediary's insolvency. The way depositaries today protect their client assets in those markets, is by opening single beneficiary accounts, very often at sub-custodian and central securities depositary level.

Additionally, and depending on the specific circumstances of each country, EFAMA believes that there are indeed a number of alternative or additional measures that can potentially be taken by the depositary to mitigate the risks related to the insolvency of a sub-custodian in jurisdictions that do not recognize the effects of segregation:

- Disclosure to the AIF and AIFM so that this aspect of custody risk is properly taken into account in the investment decision
- Depositaries taking such measures as possible in the local jurisdictions to make the assets as "insolvency-proof" as possible based on local law advice
- Depositaries might undertake appropriate levels of ongoing monitoring to ensure that the relevant sub-custodian continues to comply with the criteria for selection set out in Box 88 – this may involve an enhanced level of credit monitoring or enhanced levels of reconciliations work or other measures to pick up any early warning signals of potential problems
- Crucially, foreign players can be a powerful voice to incentivize legislators, regulators, local market participants in a jurisdiction to improve their client asset protection regimes or processes.

As regards item 2 in Box 89, the depositary should be bound to notify the AIF/AIFM when it becomes aware that the segregation of assets is not (or no longer) sufficient to ensure protection from insolvency of a sub-custodian in a specific jurisdiction. In case no adequate notification has been made, the loss of assets as a result of such insolvency should not be considered an external event in accordance with Box 91.

In which countries would this be the case? Please specify the estimated percentage of assets in custody that could be concerned.

EFAMA is not in a position to provide a complete list of countries where the effects of segregation are not recognized. To give an order of magnitude, one EFAMA member, that is also a leading provider of these services, has estimated that it is acting through the opening of single beneficiary accounts (as described above in our answer to question 46) in about 1/3 of the 105 markets in which it operates, out of legal/risk concerns for clients' assets. Assets held in those (mostly emerging) markets are estimated to be 3% of total holdings for this service provider.

EFAMA would strongly welcome if ESMA could set up and make publicly available a list of those countries, in order to facilitate adequate management of related insolvency risks by both the depositary and the AIFM.

V.IV. The depositary's liability regime

1 Loss of financial instruments

Box 90

Definition of loss

1. Financial instruments held in custody by the depositary or, as the case may be, by a sub-custodian should be considered 'lost' within the meaning of Article 21 (12) if one of the following conditions is met:
 - (a) a stated right of ownership is uncovered to be unfounded because it either ceases to exist or never existed;
 - (b) the AIF has been permanently deprived of its right of ownership over the financial instruments;
 - (c) the AIF is permanently unable to directly or indirectly dispose of the financial instruments.
2. The assessment of the loss of financial instruments must follow a documented process readily available to competent authorities and lead to the notification of investors in a durable medium taking into account the materiality of the loss.

Where an AIF is permanently deprived of its right of ownership in respect of a particular instrument, but this instrument is substituted by or converted into another financial instrument or instruments, for example in situations where shares are cancelled and replaced by the issue of new shares in a company reorganisation, this is not considered to be an example of the loss of financial instruments held in custody.

In case of insolvency of a sub-custodian, financial instruments should be considered 'lost' as soon as one of the conditions set out in §1 is met with certainty and at the latest, at the end of the insolvency proceedings. To that end, the AIFM should monitor closely the proceedings to determine whether all or part of the financial instruments entrusted to the sub-custodian are effectively lost.

In case of a fraud whereby the financial instruments have never existed or have never been attributed to the AIF (e.g., as a result of a falsified evidence of title, accounting fraud, etc.), all conditions described in §1 should be deemed to be met.

Box 90

EFAMA approves the principle-based approach set out in Box 90 rather than a typology or list of situations where the instruments would be considered lost (as a list is by definition limitative and, therefore, would most likely not encompass all situations) and believes that the criteria set out by ESMA to determine when a financial instrument is to be considered lost are appropriate (although, in practice, it should be recognized that the 'permanent' nature of a situation may sometimes be difficult to assess with certainty).

EFAMA also supports the explanatory notes 19 and 21 (pages 181 and 182 of the Consultation Paper) whereby it is primarily to the AIFM to determine whether the financial instruments are lost (or, ultimately to the relevant courts in case of dispute between the AIFM and the depositary). However, EFAMA holds the view that the depositary should be bound to cooperate in good faith to the establishment of the documented process set out in Box 90 item 2 and to share with the AIFM any document or evidence likely to facilitate the assessment of the loss. Additionally, in the case of an insolvency of the sub-custodian, EFAMA believes that it is the duty of the depositary to monitor the proceedings and keep the AIFM informed so that the AIFM, in consultation with the depositary, can decide when a financial instrument is lost. The penultimate paragraph in Box 90 should be amended to reflect this.

2 External events beyond reasonable control

Box 91

Definition of 'external event beyond the depositary's reasonable control, the consequences of which were unavoidable despite all reasonable efforts to the contrary'

The depositary will not be liable for the loss of financial instruments held in custody by itself or by a sub-custodian if it can demonstrate that all the following conditions are met:

1. The event which led to the loss did not occur as a result of an act or omission of the depositary or one of its sub-custodians to meet its obligations
2. The event which led to the loss was beyond its reasonable control, i.e. it could not have prevented its occurrence by reasonable efforts
3. Despite rigorous and comprehensive due diligences it could not have prevented the loss. Subject to requirements of §1 and §2 being fulfilled, the depositary or the sub-custodian could be regarded as having made reasonable efforts to avoid a loss of a financial instrument held in custody if it can prove that it has taken all of the following actions:
 - (a) it has ensured that it has the structures and expertise that are adequate and proportionate to the nature and complexity of the assets of the AIF, to identify in a timely manner and monitor on an ongoing basis any external events which it considers may result in a loss of a financial instrument held in custody
 - (b) it has reviewed on an ongoing basis whether any of the events it has identified under point

- (a) present a significant risk of loss of a financial instrument held in custody
- (c) where it has identified actual or potential external events which it believes present a significant risk of loss of a financial instrument held in custody, it has taken appropriate actions, if any, to prevent or mitigate the loss of financial instruments held in custody

The above described conditions will apply to the delegate when the depositary has contractually transferred its liability to a sub-custodian.

Box 91

The definition of an external event and the consequential liability test has raised differences of opinions within the EFAMA membership arising out of different legal interpretation of domestic custody laws in member states. While the Level 1 Directive sought to provide a more unified approach to liability it, of course, did not alter basis provisions of national custody law. The liability test has to be read in conjunction with the requirements for “loss”, “segregation” and “due diligence” in Boxes 88, 89 and 90 which together with proposed enhancements will constitute a robust regime for the holding of assets in custody which will limit the circumstances in which a loss will arise at all. This will then assist greatly in ensuring that any consequential increase in liability can be subject to an appropriate risk assessment and be accurately priced by custodians. While the debate on the liability standard has been vigorous and is not resolved, EFAMA members do not want it to distract from the key concerns of the ESMA guidance which are aimed at preventing a loss from occurring in the first place

The different opinions within the EFAMA membership are essentially related to the definition of external events in the context of the delegation by the depositary of its custody functions to a sub-custodian as described under item 1 of Box 91:

Some EFAMA members support the approach set out in item 1 of Box 91 according to which acts and omissions of the sub-custodian leading to the loss (as defined under Box 90) of a financial instrument, should be considered an “internal” event for the depositary and this, regardless of the fact whether the sub-custodian is an affiliate of the depositary or a third party custodian. Indeed, they consider that this approach is a reflection of the overarching principle of the Level 1 text following which “*The depositary’s liability shall not be affected by any delegation referred to in paragraph 11*” (Article 21.13, first paragraph of the AIFMD). Should an ‘act or omission’ of a sub-custodian be considered an external event for the depositary, this would have for consequence that the same type of event (e.g. an accounting or operational error causing a loss of financial instruments) would be treated differently if it happens at the level of the depositary (where it would be treated as an internal event) or if it happens at the level of the sub-custodian (where it would be treated as an external event, therefore giving the depositary the possibility to avoid liability for the loss if it can demonstrate that it was ‘beyond its reasonable control’). As a result, the above mentioned overarching principle would no longer be respected. In this context, one should also bear in mind that (except in the case of a contractual discharge of liability foreseen under Article 21.13

paragraph or 21.14 of the AIFMD) the AIFM has no direct contractual relationship with the sub-custodians, so that the AIFM's only recourse is in contract against the depositary as lead custodian.

However, other EFAMA members are of a different opinion and consider that, from an investor perspective, it would be reasonable for the depositary to be exonerated from liability provided it can prove that it fulfilled the segregation and due-diligence requirements as set down in the Directive. In their opinion, it should be clarified that the act or omission of the sub-custodian should be considered as an external event with respect to the depositary if it did not occur as a result of a wrongful act or omission of the depositary in respect to its duties in relation to the delegation of custody. Among these other members, some have an 'intermediate' position, in the sense that they argue that paragraph 1 of Box 91 should be restricted to cover acts and omissions of the depositary and of sub-custodians who are affiliates of the depositary (in the widest sense of the term affiliate) so that only such events are "internal".

Finally, some members also expressed concerns about the position of a Depositary that wishes to terminate the agreement following the notification of a custody risk to the AIFM as described in the explanatory text (items 38 and 39 on page 186 of the Consultation Paper). The proposed system is deemed not realistic and too long and should be re-written.

3 Objective reasons to contract a discharge

Box 92

Objective reasons for the depositary to contract a discharge

The depositary will be deemed to have an objective reason to contractually discharge itself of its liability in accordance with the requirements set forth in Article 21 (13) if it can demonstrate that:

Option 1

1. it had no other option but to delegate its custody duties to a third party (e.g. as a result of legal constraints); or
2. it has agreed with the AIF or as the case may be the AIFM through a written agreement 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).

Option 2

Where the AIF or, as the case may be, the AIFM and the depositary have explicitly agreed through a written contract that the depositary can discharge its responsibility, it should be considered that the requirement to have an objective reason is fulfilled.

Box 92

A large majority of EFAMA members are of the opinion that Option 2 is unacceptable and is incompatible with the Level 1 text (in particular Art. 21.13(c) AIFMD following which the written contract between the depositary and the AIF/AIFM must establish the objective reason to contract a discharge of the depositary's liabilities. Consequently, the fact that the written contract explicitly provides that the depositary can discharge its responsibility can never be in itself a sufficient objective reason to do so. The objective reason to contract a discharge should always be justified by reference to the best interest of the AIF's investors.

Therefore, they have a preference for Option 1 as it provides clarity from the outset as to the circumstances in which the depositary might contractually discharge itself from liability.

Q47: What are the estimated costs and consequences related to the liability regime as set out in the proposed advice? What could be the implications of the depositary's liability regime with regard to prudential regulation, in particular capital charges?

Question not answered.

Q48: Please provide a typology of events which could be qualified as a loss in accordance with the suggested definition in Box 90

EFAMA strongly supports the principle based approach laid down in Box 90 and does not believe that it would be helpful to provide a typology of events which could be qualified as a loss. A list by its very nature is restrictive and it is impossible to properly capture all events which would qualify as a loss.

Q49: Do you see any difficulty with the suggestion to consider as an external event the fact that local legislation may not recognize the effects of the segregation requirements imposed by the AIFMD?

EFAMA recognizes that the application of the criteria set out in Box 91 to situations where the local legislation does not recognize the effects of the segregation will, in a number of cases, lead to the conclusion that this situation indeed constitutes an "external event beyond the reasonable control of the depositary". However, this will not always and automatically be the case.

As already mentioned in our answer to question 46, the depositary should be bound to notify the AIF/AIFM when it becomes aware that the segregation of assets is not (or no longer) sufficient to ensure protection from insolvency of a sub-custodian in a specific jurisdiction. In case no adequate modification has been made, the loss of assets as a result of such insolvency should not be considered an external event in accordance with Box 91.

Q50: Are there other events which should specifically be defined/presumed as “external”?

EFAMA disagrees with the fact that some types of events should be presumed *a priori* to be “external” to the depositary. This is not consistent with the principle-based approach chosen by ESMA.

Although some types of events (e.g. acts of God) are very likely to fulfill the criteria set out in Box 91, we believe that it always depends on the facts and circumstances of each individual case and that each event should first pass the test of the 3 criteria set out in Box 91 before it can be considered “external and beyond the reasonable control of the depositary”.

Q51: What type of event would be difficult to qualify as either “internal” or “external” with regard to the proposed advice? How could the “external event beyond reasonable control” be further clarified to address those concerns?

Question not answered.

Q52: To what extent do you believe the transfer of liability will / could be implemented in practice? Why? Do you intend to make use of that provision? What are the main difficulties that you foresee? Would it make a difference when the sub-custodian is inside the depositary's group or outside its group?

Question not answered.

Q53: Is the framework set out in the draft advice considered workable for non-bank depositaries which would be appointed for funds investing mainly in private equity or physical real estate assets in line with the exemption provided for in Article 21? Why? What amendments should be made?

Question not answered.

Q54: Is there a need for further tailoring of the requirements set out in the draft advice to take into account the different types of AIF? What amendments should be made?

Question not answered.

VI. Possible Implementing Measures on Methods for Calculating the Leverage of an AIF and the Methods for Calculating the Exposure of an AIF

General comments

EFAMA points out that under the current proposals the administrative burden of thousands of UCITS-like AIFs will increase substantially, although their risk characteristics are the same as UCITS', most of them are unsophisticated funds, and in many Member States they are regulated in the same way as UCITS. In their respect, the proposed advice is deemed excessively burdensome and disproportionate to their risk characteristics. **These UCITS-like AIFs are currently applying the CESR Guidelines on risk measurement and the calculation of global exposure and counterparty risk for UCITS (CESR/10-788), and a change in calculation methodologies will cause high costs and duplication within the fund management company. We encourage ESMA to consider ways to simplify provisions for such AIFs.**

EFAMA also considers that for structured AIFs a similar grandfathering clause should be foreseen as the one in ESMA's Guidelines to competent authorities and UCITS management companies on risk measurement and the calculation of global exposure for certain types of structured UCITS published on 14 April 2011 (ESMA/2011/112 – Guideline 1 – Para. 4).

EFAMA members are concerned that the technical advice proposals place too much importance on leverage, and in particular gross leverage, as a useful statistic for regulators and investors. Gross leverage does not measure, and is poorly correlated with the effective leverage, the risk of a portfolio for investors, or the systemic risk that an AIF may pose.

Leverage is only one of many helpful measures of the risk of a portfolio. Taken alone – or with undue significance placed upon it – any one risk measure can be misleading and dangerous for regulators and investors. The quest for a unique measure for systemic risk (for regulators) and to help investors assess AIF risk is unlikely to succeed.

From the explanatory text we believe ESMA wants to use gross leverage to address three distinct issues:

- Market Risk / Volatility
- Counterparty Risk
- Liquidity Risk

We would suggest that gross leverage is a highly misleading proxy for these three important risks. Unfortunately this simple measure is too simple to achieve the aims set out for it by ESMA.

Market Risk / Volatility:

- The relationship between gross leverage and volatility is not intuitive. Gross leverage appears to be at best no guide to volatility and can often be deeply misleading, as investment risk can often be negatively correlated with gross leverage.

- The volatility created by long leverage is determined by the volatility of the underlying asset. 10x leverage into a short dated US Treasury may create substantially lower levels of volatility than 1x leverage into emerging market shares. In this example quoting a gross leverage number alone would be highly misleading in judging the riskiness of a fund.
- The second key aspect is whether the leverage is part of a portfolio with negatively correlated assets (where certain trades expected to move in opposite direction from each other). For example, a portfolio that is long one oil stock and short another oil stock may have a leverage of 2x but would present substantially lower volatility than a 1x long oil stock position. Once again, quoting a gross leverage number would give the opposite information on volatility to investors and regulators.
- According to our members, funds with high levels of gross exposure tend to be invested in very low volatility asset classes, and be substantially hedged. In many instances the realised volatility of such strategies is low.
- Another example is money market funds invested in fixed rate instruments with derivatives swapping the fixed rate into floating rate. With the gross leverage methodology described in Box 95, the gross leverage of such a money market fund would be 2x!
- We would suggest that volatility, realised drawdown or VAR may be helpful in understanding volatility in a portfolio and the risk that the investor may lose capital due to market moves, or a failure of Alpha.

Counterparty Risk:

- We understand that certain regulators view hedging positions as contributing to counterparty risk, and therefore gross exposure would be a proxy for counterparty risk.
- We would suggest that (a) undercollateralized counterparty exposures and (b) collateral quality are more appropriate measures of this risk. In the event of a counterparty failure, the collateral serves to "make whole" the AIF; if the collateral is either less than the exposure (undercollateralization) or is of insufficient quality to recover the lost value, counterparty risk has not been sufficiently mitigated.
- Exchange-traded derivatives typically have frequently collateralized margin specifically to mitigate this risk; additionally, the exchange represents a central clearing counterparty, further mitigating systemic linkages between participants
- OTC derivatives typically use bi-lateral collateralization to mitigate this risk.
- In the event of a counterparty failure, the collateral serves to "make whole" the AIFM; if the collateral is either less than the exposure (undercollateralization) or is of insufficient quality to recover the lost value, counterparty risk has not been sufficiently mitigated.
- As a result, taking gross exposure as a proxy for counterparty risk is deeply misleading for both regulators and investors.

Liquidity Risk:

- A highly leveraged portfolio may find it more difficult to liquidate its positions when faced with redemptions.
- As with the volatility example below, the nature of the underlying investment may be more important than the level of leverage in determining the portfolio's ability to respond to

redemptions or a market shock. For example a lightly leveraged real estate portfolio will be far less liquid than a government debt AIF with high levels of gross leverage.

- Gross leverage is an unhelpful proxy for liquidity risk and perhaps exploring other measures may be more valuable.

Given that gross leverage does not helpfully measure volatility, counterparty risk or liquidity risk, EFAMA does not consider that it is a helpful headline measure of the riskiness of an AIF – either from a systemic risk or investor risk perspective.

We would suggest that gross leverage should be de-emphasised and a more nuanced approach including VAR, volatility, drawdown, net counterparty risk, and liquidity measures should be adopted.

Regarding the commitment method, due to the restrictive definitions of netting and hedging our members do not believe this will be a very helpful measure – and in most cases it will result in a number close to the gross method number. Furthermore, it does not correspond to current investor understanding of the net leverage or net exposure of an AIF – which makes use of offsetting arrangements.

As a result, many AIFMs will opt to use the advanced method but many different calculation methodologies will be used, and therefore its usefulness to investors will be limited.

Notwithstanding the above remarks, some EFAMA members consider that for funds with only a small degree of leverage, the effort of netting may be more burdensome than just adding up – as it requires accurate database management efforts to keep track of which asset is used as a hedge for what asset. Hence, in their opinion an AIFM should not be obliged to use netting⁶ if the leverage is low anyway. Under such circumstances, the obligation to carry out two calculations (gross and netted) would create an additional workload and have no additional information value.

Box 93

General Provisions on Calculating the Exposure of an AIF

1. ESMA has been requested by the Commission to provide advice on the appropriate method or methods for the calculation of leverage for the purposes of Directive 2011/61/EU. ESMA considers that in all cases the overall leverage of an AIF can be expressed as a ratio between the exposure of an AIF and its net asset value; however, the method of calculating exposure needs to be further defined.
2. AIFMD shall calculate leverage as the exposure of the AIF divided by its net asset value, where the exposure of the AIF is calculated in accordance with paragraph 3 or 4.
3. AIFM shall calculate the exposure of each AIF under its management in accordance with the

⁶ The commitment approach under the UCITS Directive creates the possibility – but not the obligation – to net.

Gross Method set out in Box 95 and the Commitment Method set out in Box 96. The exposure of the AIF should represent the extent to which the AIF may be impacted by the market risks attributable to its positions.

4. To comply with its obligations with respect to Article 25(3) of Directive 2011/61/EU, AIFM may in addition to calculating exposure under the Gross Method and Commitment Method, and upon notification to the competent authorities of its home Member state, calculate the exposure of an AIF under its management in accordance with the Advanced Method set out in Box 97.
5. The notification referred to in paragraph 4 may be made by the AIFM to the competent authorities of its Home Member State at the same time as the AIFM applies for authorization in accordance with Article 7 of Directive 2011/61/EU and must include:
 - (a) The name of the AIF for which the AIFM will use the Advanced Method to calculate exposure;
 - (b) An explanation of why the Gross Method and the Commitment method do not provide an accurate reflection of the exposure of the AIF it manages;
 - (c) The methodology employed for the calculation of the exposure of the AIF in accordance with the Advanced method; and
 - (d) A justification of the key assumptions used in the calculation of the exposure of the AIF under the Advanced Method.
6. The competent authorities of the home Member State of the AIFM may request additional information to that contained in the notification referred to in paragraph 4.
7. The AIFM should be able to demonstrate that the exposure calculated in accordance with Box 97 has been undertaken in a conservative manner which has taken account of the material risks to which the AIF is exposed and therefore does not understate the exposure of the AIF.
8. AIFM shall, on request, make available to investors the methodology employed for the calculation of the exposure of an AIF under its management in accordance with the Advanced Method.
9. AIFM shall have appropriately documented procedures to calculate the exposure of each AIF under its management in accordance with the Gross method, the Commitment Method and, in respect of each AIF for which the AIFM has submitted the notification referred to in paragraph 4, the Advanced Method. The AIFM shall also ensure that the calculation is consistently applied.
10. Where changes are made to the procedures referred to in paragraph 8 that impact the calculation of the exposure of the AIF and result in a material change to the level of leverage disclosed by the AIFM in respect of the AIF in accordance with Article 23(5) of Directive 2011/61/EU, the AIFM shall notify the AIF's investors and the competent authorities of the home Member State. The notification shall include the reasons for the change in procedures and the impact of the level of leverage.
11. To comply with its obligations in accordance with Article 23(5) of Directive 2011/61/EU and Box 108, AIFM shall disclose to investors on a regular basis, the level of leverage with reference to the Gross method and must in addition disclose the level of leverage with reference to the Commitment Method or, where applicable, the Advanced Method.

Box 93

EFAMA strongly disagrees with the proposal in Box 93 to require the calculation of the AIF exposure according to two or even three different methodologies (Para. 3 and, 9), as well as the disclosure of the level of leverage according to two methodologies (Para. 11). The calculation requirement is overly burdensome and the disclosure of multiple figures is bound to create confusion among investors. **Our members suggest that calculation of exposure according to a single methodology should be sufficient, and that a single leverage calculation should be disclosed to investors. The choice of the calculation methodology should be left to the AIFM, who will be in a position to choose the methodology most suitable for the profile of the AIF.** We encourage ESMA to include in its advice the reasons for the necessity to perform multiple calculations (and to disclose multiple leverage figures).

Such requirement for multiple calculations will be particularly burdensome for thousands of UCITS-like mostly retail AIFs, which are currently subject to exhaustive national legislation, very often following the UCITS standards and thus complying with CESR's Guidelines on Risk Measurement (CESR/10-788). Unnecessary modifications should be avoided under the AIF regime, in order to prevent excessive implementation efforts and costs. The requirement for the disclosure of multiple leverage figures should also be mitigated for these funds, as such information would hardly be useful to retail investors.

We disagree with ESMA's expectation in paragraph 9 of the Introductory Text that the Commitment methodology will lead to a reduced administrative burden. On the contrary, EFAMA members expect that the process of establishing which hedging and netting arrangements are acceptable will be very burdensome (please see also our comments on Box 96).

EFAMA strongly disagrees with ESMA's assessment of VAR in Para. 10 of the Introductory Text. VAR is a helpful methodology in many market conditions. No single risk measure can explain portfolio risk, but VAR has the advantage of being a measure of expected outputs (i.e., the level of expected loss with a confidence interval), rather than a measure of inputs (i.e., gross leverage). Whilst VAR has its limitations, it is one of the more helpful measures of portfolio risk, when taken together with other appropriate portfolio analytics and attribution techniques. Please see also our comments on Box 97.

If the use of VAR is allowed as EFAMA suggests, the formula for the calculation of leverage in Para. 2 of Box 93 shall require a modification.

Some EFAMA members consider that the proposed methods for calculating the exposure of an AIF are only relevant for AIFs which utilise leverage according to Article 4 (1) (v) of the AIFM Directive. ESMA should therefore clarify that these requirements do not apply to other AIFs which do not utilise leverage.

Some members consider it is very important that the notification for the use of the advanced method should not be turned into an authorisation procedure in practice. Furthermore, divergent

interpretations by Competent Authorities should be avoided as far as possible, to maintain harmonisation and a level playing field among AIFMs.

Box 94

Exposure Related Definitions

“Netting arrangements” means combinations of trades on financial derivative instruments and/or security positions which refer to the same underlying asset, irrespective – in the case of financial derivative instruments – of the contracts’ due date and where those trades on financial derivative instruments and/or security positions are concluded with the sole aim of eliminating the risks linked to positions taken through the other financial derivative instruments and/or security positions.

“Hedging arrangements” means combinations of trades on financial derivative instruments and/or security positions which do not necessarily refer to the same underlying asset and where those trades on financial derivative instruments and/or security positions are concluded with the sole aim of offsetting risks linked to positions taken through the other financial derivative instruments and/or security positions.

“Offsetting arrangements” means combinations of trades on financial derivative instruments and/or security positions which do not necessarily refer to the same underlying asset and where those trades on financial derivative instruments and/or security positions are concluded with the aim of offsetting risks linked to positions taken through the other financial derivative instruments and/or security positions. Offsetting arrangements may include combinations of trades which aim to generate a return.

“Financial derivative instruments” means options, futures, swaps, forward rate agreements and other derivative or embedded derivative positions including derivative contracts as defined in point 4 to 10 of Section C of Annex I of Directive 2004/39/EC.

“Capital commitment” means the contractual commitment of an investor to provide the AIF with an agreed amount of investment on request by the AIFM.

Box 94

The definitions of Netting and Hedging are highly restrictive and do not reflect current industry practice.

The language referring to *“sole aim of offsetting”* seems unhelpfully restrictive. Risk is managed at a portfolio level – therefore any single trade will play multiple roles in a portfolio.

Box 95**Gross Method of Calculating the Exposure of the AIF**

1. The exposure of an AIF calculated in accordance with the Gross Method is the sum of the absolute values of all its financial derivative instrument, non-financial-derivative instrument positions and other asset or liability positions calculated in accordance with Article 19 of Directive 2011/61/EU and its delegated acts, subject to the following criteria:
 - (a) The value of any cash and cash equivalents which provide a return at the risk-free rate and are held in the base currency of the AIF should be excluded from the calculation;
 - (b) Financial derivative instruments should be converted into the market value of the equivalent underlying assets of that derivative;
 - (c) Liabilities that arise through cash borrowings where the amounts of that payable are known and exposed to insignificant market risks should be excluded from the calculation; and
 - (d) Positions within repurchase or reverse repurchase agreements should be included in the calculation in accordance with paragraph 10 and paragraph 11 of Box 98.
2. Borrowing arrangements entered into by the AIF are excluded if these are temporary in nature and relate to and are fully covered by capital commitments from investors.
3. To the extent that it is not included after considering paragraphs 1 and 2, exposure which is contained in any financial and/or legal structures involving third parties controlled by the relevant AIF should be included in the calculation of the exposure where the structures referred to are specifically set up to directly or indirectly increase the exposure at the level of the AIF. In particular, for private equity and venture capital funds this means that exposure that exists at the level of a portfolio company is not intended to be included when referring to such financial or legal structures and therefore should not be included in the calculation of the exposure of an AIF.

Box 95

Regarding the gross method, please see our general comments. Regarding the reference to the risk-free rate in Para. 1 (a), please see our reply to Q58.

As previously stated, EFAMA believes that the calculation of exposure according to a single methodology (at the choice of the AIFM) should be sufficient, and that only one leverage calculation should be disclosed to investors, to avoid confusion. However, if regulators consider that the calculation of the gross method is absolutely necessary and it is not the method chosen by the AIFM, then a second calculation of the exposure should be performed according to the gross method, but only for reporting purposes to the Competent Authorities.

Some EFAMA members point out that for funds that (almost) entirely invest in futures the outcome of the gross or commitment methods do not provide an appropriate indication of the risk incurred. For futures it is common to use the margin to equity ratio. Margin to equity ratio is the total margin posted by the AIF divided by the total assets of the AIF. For AIFs investing in futures the margin to equity ratio is the main indicator.

Other members consider that borrowing should be excluded from the gross method when that borrowing is reinvested – as the re-investment is already captured.

Some among our members consider that -- should the gross leverage calculation be maintained – it should be possible to deduct netting/hedging arrangements and to use Boxes 3 & 4 of the CESR Guidelines.

Explanatory Text Paragraph 25 (4) - ESMA's proposal explicitly refers to the fact that, when calculating the exposure of a private equity fund, the leverage of a portfolio company should not be included in the calculation of the exposure of an AIF. However, it should be clarified that leverage in any holding company structure is also to be excluded.

Box 96

Commitment Method of Calculating the Exposure of an AIF

1. The exposure of an AIF calculated in accordance with the Commitment Method is the sum of the absolute values of all its financial derivative instrument, non-financial derivative instrument positions and other asset or liability positions calculated in accordance with Article 19 of Directive 2011/61/EU and its delegated acts, subject to the following criteria:
 - (a) Cash and cash equivalent positions, financial derivative instruments, liabilities that arise through cash borrowing and positions within repurchase or reverse repurchase agreements are subject to the adjustments in paragraph 1(a)-(d) of Box 95;
 - (b) Positions which are deemed to be in hedging arrangements in accordance with Box 94 which satisfy the conditions in paragraph 2 should not be included in a calculation;
 - (c) Positions which are deemed to be in netting arrangements in accordance with Box 94 which satisfy the requirements of paragraph 4 should be included at their total combined net exposure.
2. Hedging arrangements may only be taken into account when calculating the exposure of an AIF if they comply with all the criteria below:
 - (a) The positions involved within the hedging relationship do not aim to generate a return;
 - (b) There should be a verifiable reduction of market risk at the level of the AIF;
 - (c) The risks linked to financial derivative instruments, i.e., general and specific, if any, should be offset;
 - (d) The hedging arrangements should relate to the same asset class; and
 - (e) They should be efficient in stressed market conditions.
3. Notwithstanding paragraph 2, financial derivative instruments used for currency hedging purposes (i.e. that do not add any incremental exposure, leverage and/or other market risks) should not be included in the calculation.
4. An AIFM may net positions:
 - (a) Between financial derivative instruments, provided they refer to the same underlying asset, even if the maturity date of the financial derivative instruments is different; or
 - (b) Between a financial derivative instrument whose underlying asset is a transferable security, money market instrument or units in collective investment undertaking as

defined in point 1 to 3 of Section C of Annex 8 of Directive 2004/39/EC and that same corresponding underlying asset.

5. AIFM that manage AIF that, in accordance with their core investment policy, primarily invest in interest rate derivatives may make use of specific duration netting rules in order to take into account the correlation between the maturity segments of the interest rate curve.
6. Borrowing arrangements entered into by the AIF and exposure contained in financial and/or legal structures involving third parties controlled by the relevant AIF should be subject to the adjustments in paragraph 2 and 3 of Box 95.
7. To the extent that it is not included after considering paragraphs 1 and 2 exposure which is contained in any financial and/or legal structures involving third parties controlled by the relevant AIF should be included in the calculation of the exposure where the structures referred to are specifically set up to directly or indirectly increase the exposure at the level of the AIF. In particular for private equity and venture capital funds this means that exposure that exists at the level of a portfolio company is not intended to be included when referring to such financial or legal structures and therefore should not be included in the calculation of the exposure of an AIF.

Box 96

The Commitment method proposal seeks to generate a version of Net Exposure, but the definitions of an eligible hedge are so restrictive as to be unhelpful. This is not an accepted definition of Net Exposure.

In particular, the restriction that the "Hedging arrangements do not generate a return" would prohibit the majority of equity long/short strategies from using their short positions to net their long positions. Hence, gross exposure would be the same as Commitment exposure in an equity long short AIF – despite the fact that the beta might be close to zero.

This will encourage managers to create their own methodologies in the advanced method – which may not be good for investor transparency – and would unnecessarily tax regulatory resources reviewing methodologies for vanilla funds seeking to follow standard industry practice. These points are clearly made in Paragraph 38 of the Explanatory text.

As the current definition of the commitment method is cumbersome and unhelpful, many EFAMA members suggest that it should be modified and replaced with a Net Exposure calculation which permits offsets, reflecting industry standards.

Other EFAMA members consider it important that ESMA should ensure consistency of the commitment method with the UCITS calculation methodology for the commitment approach.

It is common for real estate funds to enter into an Interest Rate Swap to reduce the risk from interest rate movements that are relevant to borrowings. This is a true hedge and reduces the risk to the AIF investor. However, this does not seem to fall into paragraph 2 or 3 of Box 96. We therefore strongly advise that paragraph 3 is extended to cover interest rate hedges.

According to Paragraph 4 (a), some netting between interest rate derivatives of different durations can be performed if a degree of their correlation is taken into account. Further clarification on this would be helpful in order to understand how this will apply in practice.

Many structured funds use barrier options, for example to pay “coupons” when some market conditions are realized, or to protect the capital of the investors as long as some equity index does not fall below a certain predetermined level. Such barrier options can have infinite delta around the barrier and close to maturity, and thus the commitment method cannot be applied. Some EFAMA members consider therefore that structured AIFs should be allowed to use the optional methodology described in ESMA's Guidelines to competent authorities and UCITS management companies on risk measurement and the calculation of global exposure for certain types of structured UCITS published on 14 April 2011 (ESMA/2011/112).

Box 97

Advanced Method of Calculating the Exposure of an AIF

1. An AIFM, having notified the competent authorities of its home Member State in accordance with Box 93, must calculate the exposure of an AIF it manages in accordance with the Advanced Method for all the assets of the AIF on the basis of the requirements below:
 - (a) Take into account paragraph 3 of Box 95;
 - (b) Calculate exposure for each financial derivative instrument position with reference to the Commitment Method in accordance with Box 96 where that calculation provides a meaningful result;
 - (c) In all other cases, the AIFM should employ a calculation method that it considers will result in an appropriate approximation of the AIF's exposure, which may include the estimated maximum loss;
 - (d) Offsetting arrangements may be taken into account in relation to all assets if they offset risks linked to all or part of an asset or liability of the AIF and the following conditions are satisfied:
 - (i) The AIFM can demonstrate that the arrangements are likely to remain materially effective in times of stressed market conditions; and
 - (ii) There is a verifiable reduction in risk at the level of the AIF;
2. In calculating the exposure of an AIF under the Advanced Method the AIFM should always take into account the following principles:
 - (a) The methodology should be fair; conservative and not underestimate nor give a misleading view to investors of the exposure of the AIF;
 - (b) The approach must be consistently applied over time and where applicable, between AIFs; and
 - (c) The AIFM should demonstrate that the calculation method employed in accordance with paragraph 1(b) and the positions that are offset in accordance with paragraph 1(c) are consistent with how the AIFM manages risk within that AIF.

Box 97

The advanced method as foreseen by ESMA would allow for an amended/hybrid version of the commitment method exposure calculation, where alternative exposure methodologies can be substituted for the parts of the portfolio where the commitment method does not provide reasonable results. In this sense, it is helpful, but we fail to see how the advanced method will reduce complexity.

Our members disagree with the requirement to calculate the advanced method besides the commitment method, instead of as an alternative to it.

Box 98

Methods of Increasing the Exposure of an AIF

When calculating exposure, AIFM should take into account the following non-exhaustive methods.

1. **Unsecured Cash borrowings**: When cash borrowings are invested they have the propensity to increase the exposure of the AIF by the total amount of those borrowings: If cash borrowings of €100m were used to purchase securities of the same value there is the possibility that the value of the securities could fall to €- with the result that the AIF would be exposed to the full €100m. However, if the cash borrowings are not invested but remain in cash or cash equivalents which remain the base currency of the AIF they will not increase the exposure of the AIF.
2. **Secured Cash borrowing**: Similar to the above but the loan may be secured by a pool of assets or a single asset. If the cash borrowings are not invested but remain in cash in the base currency of the AIF they will not increase the exposure of the AIF.
3. **Convertible borrowings**: purchased debt which has the ability, under certain circumstances, to enable the holder or issuer to convert that debt into another asset. The exposure of the AIF is the market value of such borrowings.
4. **Interest rate swaps**: An interest rate swap is an agreement to exchange interest rate cash flows, calculated on a notional principal amount, at specified intervals (payment dates) during the life of the agreement. Each party's payment obligation is computed using a different interest rate based on the notional exposures.
5. **Contracts for Differences**: CFD is an agreement between two parties – the investor and the CFD provider – to pay the other the change in the price of an underlying asset. Depending on which way the price moves, one party pays the other the difference from the time the contract was agreed to the point where it ends. Exposure is the market value of the underlying asset.
6. **Futures contracts**: An agreement to buy or sell a stated amount of a security, currency, commodity, index or other asset at a specific future date and at a pre-agreed price. The exposure is the market value of the equivalent underlying asset.
7. **Total Return Swaps**: A total return swap is an agreement in which one party (total return payer) transfers the total economic performance of a reference obligation to the other party (total return receiver). Total economic performance includes income from interest and fees, gains or losses from market movements, and credit losses. The exposure of the AIF is the market value

of the equivalent reference assets which have a bearing of the economic performance of the swap.

8. **Forward agreements:** A forward is a customized, bilateral agreement to exchange an asset or cash flows at a specified future settlement date at a forward price agreed on the trade date. One party to the forward is the buyer (long), who agrees to pay the forward price on the settlement date; the other is the seller (short), who agrees to receive the forward price. Entering into a forward contract typically does not require the payment of a fee. The exposure of the AIF is notional value of the contract.
9. **Options:** An option is an agreement that gives the buyer, who pays a fee (premium), the right – but not the obligation – to buy or sell a specified amount of an underlying asset at an agreed upon price (strike or exercise price) on or until the expiration of the contract (expiry). A call option is an option to buy, and a put option an option to sell. The boundaries of the exposure of the fund will be between a potential unlimited exposure to an exposure that is limited to the higher of the premium paid or the market value of that option. To get to the point between these two bounds the exposure is the delta (Options Delta measures the sensitivity of an option's price solely to a change in the price of the underlying asset) adjusted equivalent of the underlying position.
10. **Repurchase agreements:** This transaction normally occurs where an AIF "sells" securities to a reverse-repo counterparty and agrees to buy them back at an agreed price in the future. The AIF will incur a financing cost from engaging in this transaction and therefore will need to re-invest the cash proceeds (effectively cash collateral- in financial instruments that provide a return greater than the financing cost incurred. This reinvestment of "cash collateral" means that incremental market risk will be carried by the AIF and so must be taken into account in the global exposure calculation. It is important to note that the economic risks and rewards of the "sold" securities remain with the AIF. It is also worth noting that a repo transaction will almost always give rise to leverage as the cash collateral must be reinvested at a yield greater than the financing costs incurred in order for the AIF to make a return. In the event that non-cash collateral is received as part of the transaction and this collateral is further used as part of another repo, or stock-loan agreement, the full market value of the collateral must be included in the global exposure amount. The exposure of the AIF is increased by the reinvested part of the cash collateral.
11. **Reverse repurchase agreements:** This transaction occurs where an AIF 'purchases' securities from a repo counterparty and agrees to sell them back at an agreed price in the future. AIF normally engage in these transactions to generate a low-risk money-market type return, and the 'purchased' securities act as collateral. Therefore no global exposure is generated and nor does the AIF take on the risks and rewards of the 'purchased' securities, i.e., there is no incremental market risk. However, it is possible for the 'purchased' securities to be further used as part of a repo or stock-loan transaction, as described above, and in that case the full market value of the securities must be included in the global exposure amount. The economic risks and rewards of the purchased securities remain with the counterparty and therefore this does not increase the exposure of the AIF.
12. **Securities lending arrangements:** An AIF engaging in a securities lending transaction will lend stock to a stock-borrowing counterparty (who will normally borrow stock to cover a physical short sale transaction) for an agreed fee. The stock borrower will deliver either cash or non-

cash collateral to the AIF. Only where cash collateral is reinvested in instruments that provide a return greater than the 'risk-free rate' will global exposure be created. If the non-cash collateral is further used as part of a repo or another stock lending transaction, the full market value of the securities must be included in the global exposure amount as described above. Exposure is created to the extent that the cash collateral has been reinvested.

13. **Securities borrowing arrangements:** An AIF engaging in the borrowing of stocks will borrow stock from a stock-lending counterparty for an agreed fee. The AIF will then sell the stock in the market. The AIF is now short that stock. To the extent that the cash proceeds from the sale are reinvested this will also increase the exposure of the AIF. Exposure is the market value of the sorted stocks; additional exposure is created to the extent that that cash received is reinvests.

Box 98

With reference to the definitions provided for Futures Contracts and Forward Agreements, some EFAMA members believe that the definitions are not adequate, and that ESMA should differentiate further among different types of futures and forwards. They suggest using the same wording as CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (CESR/10-788).

Box 99

Exposures involving third parties legal structures

Recital 78 of the AIFMD refers to "... any financial and/or legal structures involving third parties controlled by the relevant AIF, where the structures referred to are structures specifically set up to directly or indirectly create leverage at the level of the AIF. In particular for private equity and venture capital funds this means that, leverage that exists at the level of a portfolio company is not intended to be included when referring to such financial or legal structures. ESMA is consulting on three options to assist firms when interpreting these requirements.

Option 1

AIFMs shall include in the calculation of leverage any exposure which is contained within financial and/or legal structures involving third parties to the extent that entities involved within those structures have recourse to the AIF via cross-collateralisation or guarantees, including guarantees, where there is an expectation that the AIF will contribute to the underlying structure even though there is no legally enforceable obligation.

Option 2

AIFMs shall include in the calculation of leverage any exposure which is contained within financial and/or legal structures involving third parties to the extent that entities involved within those structure are non-listed companies or issuers controlled by the AIFM within the scope of Article 26 and have recourse to the AIF via cross-collateralisation or guarantees, including guarantees, where there is an expectation that the AIF will contribute to the underlying structure even though there is no legally enforceable obligation.

Option 3

AIFMs shall not include in the calculation of leverage any exposure which is contained within financial and/or legal structures involving third parties to the extent that the AIF is holding ordinary shares, shares in a target company or shares or units in a collective investment undertaking as an investment and the capital of the AIF that is at risk through this position is limited to the market value of those shares or units. However, AIFMs shall include in the calculation of leverage any exposure which is contained within financial and/or legal structures involving third parties to the extent that the AIF has provided guarantees for any shortfall in the value of the property relating to the underlying shares or units have been secured or where a loan has been secured on property relating to the underlying shares or units outside of a portfolio company structure by way of cross-collateralisation.

Box 99

No comments

Q55: ESMA has set out a list of methods by which an AIF may increase its exposure. Are there any additional methods which should be included?

Yes, It should be helpful to add the method for the calculation of the exposure of Credit Default Swaps to box 97, e.g. as described in CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (CESR/10-788).

In many funds which have a benchmark portfolio the primary method used to increase the relative performance is benchmark deviation in the physical investments. ESMA/2011/209 gives little insight into this method of risk taking.

Some EFAMA members consider that it would be helpful to include products (indices) with embedded leverage, for example leveraged ETFs and long-short UCITS (130/30), as on page 193 (Para. 13) ESMA mentions that leverage achieved with products where leverage is embedded in the contract should be included in the calculation.

Other members suggest including structured bonds like credit or index linked bonds, similarly to CESR's UCITS guidelines.

Q56: ESMA has aimed to set out a robust framework for the calculation of exposure while allowing flexibility to take account of the wide variety of AIFs. Should any additional specificities be included within the Advanced method to assist in its application?

ESMA rejects the use of VAR for all funds captured by the AIFMD, citing the exposure of the VAR method to the breakdown of correlations in stressed market conditions (Introductory Text to Box 93 - Paragraph 10).

EFAMA strongly disagrees and recommends that VAR be a permitted advanced monitoring method where appropriate for the particular AIF.

The range of funds covered by the AIFMD is too diverse to permit the specification of the advanced method to usefully go beyond a statement of basic principles.

As mentioned above, EFAMA members consider that for structured AIFs a similar grandfathering clause should be foreseen as the one in ESMA's Guidelines to competent authorities and UCITS management companies on risk measurement and the calculation of global exposure for certain types of structured UCITS published on 14 April 2011 (ESMA/2011/112 – Guideline 1 – Para. 4).

Q57: Is further clarification needed in relation to the treatment of contingent liabilities or credit-based instruments?

No.

Q58: Do you agree that when an AIFM calculates the exposure according to the gross method as described in Box 95, cash and cash-equivalent positions which provide a return at the risk-free rate and are held in the base currency of the AIF should be excluded?

EFAMA agrees that cash and cash equivalents should be excluded from the gross method calculation.

The use of yield to identify risk-free positions, however, is unwise, as

- (a) the comparison of the yield of positions with the yield of government bills of a defined maturity is a complex process not offered by many monitoring platforms currently in use;
- (b) yields of bills, and therefore prices, are manipulated by governments, at times volatile and in the case of the Euro not consistent from government to government; and
- (c) the yield criterion excludes a range of instruments (reverse repos, AAA rated liquidity funds) which offer higher yields, default risk reduced by collateral or diversification, and an absence of revaluation, thereby producing a conflict between the reporting standard and the best interests of investors. Consequently, the method of applying the "risk free" criterion is likely to render the reporting objective unachievable.

Consequently, EFAMA suggests deleting the words "*which provide a return at the risk-free rate*" in Para. 1 (a) in Box 95.

Q59: Which of the three options in Box 99 do you prefer? Please provide reasons for your view.

A majority of EFAMA members prefer Option 1. They consider that the approach in options 1 and 2 is preferable to that in option 3, because:

Option 3 creates uncertainty. Limb 1 specifies that AIFMs shall not include in the calculation of leverage exposures any exposure contained within third party structures where the capital at risk is not greater than the market value of its holding in the relevant shares or units. Limb 2 states that leverage shall include exposures gained through guarantees and the giving of security in specified circumstances. It is unclear what would happen where there is exposure greater than the market value of the shares but it is not gained through guarantees or the giving of security in the specified circumstances. Also, it is unclear why the calculation of leverage exposure hinges on the market value of shares rather than amount paid for such shares.

Option 1 is preferred over option 2 as it is more logically sound. Exposure on the basis of a guarantee is not dependent on whether or not the guaranteed company is listed or unlisted or whether it is controlled by the guarantor. Whether or not an exposure is realised is dependent on the terms of the guarantee, not these other factors. It is not, however, appropriate to count exposure guarantees that are not legally enforceable. The provision that “guarantees” in respect of which there is no legally enforceable obligation but “an expectation” are to be counted in the leverage calculation is ambiguous and should be deleted.

Other EFAMA members, on the contrary, prefer Option 3, some because it would allow for a more precise calculation of the exposure, and others because they consider that leverage at the level of a third party financial or legal structure controlled by the AIF should only be included in the leverage of the AIF as a result of guarantees provided by the AIF with a legally enforceable obligation;.

Q60: Notwithstanding the wording of recital 78 of the Directive, do you consider that leverage at the level of a third party financial or legal structure controlled by the AIF should always be included in the calculation of the leverage of the AIF?

No.

VII. Possible implementing measures on limits to leverage or other restrictions on the management of AIF

Box 100

Principles specifying the circumstances under which competent authorities will exercise the powers to impose leverage limits or other restrictions on AIFM

1. The competent authorities of the home Member State of the AIFM shall assess the risks that the use of leverage by an AIFM with respect to the AIFs it manages, could entail, with reference to the information provided under Articles 7(3), 15(4) and and/or reported under Article 24(4) and/or 24(5) of Directive 2011/61/EU.
2. The assessment by the competent authorities in paragraph 1 shall have regard to the extent to which the use of leverage by an AIFM, or by a group of AIFMs, could contribute to the build-up of systemic risk in the financial system, or risks creating disorderly markets.
3. If, following such assessment, the competent authorities deem it necessary to ensure the stability and integrity of the financial system, after following the required notification procedures in Articles 25(3) and 25(4), they shall impose limits or other appropriate supervisory restrictions on the use of leverage by such AIFM.
4. The following illustrative circumstances and criteria should guide the assessment undertaken by competent authorities under above Principles 1-3 to ensure the stability and integrity of the financial systems:
 - (a) Circumstances where the exposures of an AIF, or group of AIF, arising through the use of leverage by an AIFM, including those exposures resulting from financing or investment positions entered into by the AIFM, or by the AIFM on behalf of the AIF, could constitute an important source of market, liquidity or counterparty risk to a financial institution, in particular, to any such institution the competent authority deems to be systemically relevant.
 - (b) Circumstances where the activities of AIFM, or group of AIFM, in particular with reference to the types of assets in which the AIF invests and the techniques employed by the AIFM, or group of AIFM, through the use of leverage, contribute or may contribute to the downward spiral in the prices of financial instruments, or other assets, in a manner which threatens the viability of such financial instruments or other assets.
 - (c) Criteria such as the type of AIF under management, the investment strategy of the AIFM, or group of AIFM, in relation to the AIF concerned, the market conditions in which the AIFM and the AIF operate, and any likely pro-cyclical effects which may result from the imposition by the competent authorities of limits or other restrictions on the use of leverage by the AIFM or group of AIFM concerned.
 - (d) Criteria such as the size of an AIF or group of AIFs and any related impact in a particular market sector, any concentration of risks in particular markets in which an AIF or group of AIFs are invested, any contagion risk to other markets from a market where risks have been identified, any liquidity issues in particular market or sector at a given time, the scale of any asset/liability mismatch in a particular AIFM investment strategy, or any irregular evolution of prices of assets in which an AIF may be invested.
5. Competent authorities of the home Member State of the AIFM concerned shall determine the appropriate timing of any potential measures under Article 25(3) having regard to the need to avoid or minimize, as the case may be, any identified risks, including systemic risk. The timing of any such measures shall take into account the nature of the risk and degree of any likely impact on the stability and integrity of the financial system.

Box 100

No comments

Q61: Do you agree with ESMA's advice on the circumstances and criteria to guide competent authorities in undertaking an assessment of the extent to which they should impose limits to the leverage than an AIFM may employ or other restrictions on the management of AIF to ensure the stability and integrity of the financial system? If not, what additional circumstances and criteria should be considered and what should be the timing of such measures? Please provide reasons for your view.

Firstly, leverage is not a risk measure and therefore, any intervention must be based on sound analysis and evidence of systemic risk. It is essential that regulators carefully consider the impact of any restrictions they may impose on leverage, weighing the systemic benefits against potential damage to investors.

EFAMA members suggest once again that an undue focus on gross leverage is unhelpful, given its imperfect link with risk. Regulators are encouraged to take a more effective approach.

Limiting gross leverage would have contradictory effects such as preventing certain AIFs to reduce their effective leverage. As an example, if an AIF has a derivative exposure that cannot be unwound for some reasons, it may want to enter into hedging arrangements that would require entering into new derivatives, which would increase the gross exposure.

Q62: What additional factors should be taken into account in determining the timing of measures to limit leverage or other restrictions on the management of AIF before these are employed by competent authorities?

We strongly believe that these powers are used only in extreme circumstances, with transparent, objective and predictable criteria. EFAMA recommends that a mandatory first step should be for the regulator to enter into dialogue with the AIFM. Communication with the AIFM could avoid circumstances in which leverage caps were imposed through misunderstanding of an investment strategy or of the risk created by this investment strategy.

Forced deleveraging of an AIF will create material costs for investors (trading costs, and depressed asset prices); hence, the burden of proof should be set with this balance in mind. Strict confidentiality would also be required. If a regulator became concerned about long leverage in a certain sector, a public pronouncement of a leverage limit and forced deleveraging would likely cause a price collapse. This forced selling at "fire sale" prices would have a material detrimental impact on investors. AIFMs should therefore be allowed to reduce positions within a reasonable period of time and in a way that is consistent with the investors' best interests.

EFAMA also considers that regulators should consider the importance of maintaining a level playing field. If a single regulator imposes a leverage limit, then local AIFs would be forced to de-leverage, but funds in other Member States and funds outside the remit of the AIFMD would still be able to pursue their investment strategies. This would create a detrimental impact on the investors in the local AIF, while not achieving the aim of the concerned regulator.

VIII. Transparency Requirements

The transparency requirements should apply the proportionality principle as intended in the AIFMD. The suggested reporting obligations seem out of proportion for small AIFMs, and are going beyond what was first requested by the AIFMD. EFAMA is extremely concerned about especially two aspects of the transparency requirements.

Firstly, the reporting requirements to competent authorities. These are extremely onerous. We strongly believe that rather than quarterly reporting, reporting should be on an annual basis, with competent authorities having the right to request more frequent reports if appropriate.

Secondly, in respect of non-EU AIFM managing non-EU AIF who are only privately placing under Article 42 (hence need only comply with the Level 1 Chapter IV Transparency Requirements), we are concerned that the Level 2 transparency requirements suggest substantive compliance with other operational sections of the Level 1 Directive (such as risk and liquidity management and leverage). Requiring identical or substantive implementation of Level 2 transparency standards (as for EU AIFM who hold an EU-wide passport) by non-EU AIFM/non-EU AIF for a private placement benefit which is only available at the discretion of individual Member States would be disproportionate, would not reflect the final position of the Level 1 Directive and would result in a very unlevel playing field.

VIII.I. Possible Implementing Measures on Annual Reporting

Box 101

Annual Report Definitions

“Material change” (for the purposes of Article 22(2) (d) and with reference to Article 23, where appropriate means changes in information if there is a substantial likelihood that a reasonable investor, becoming aware of such information, would reconsider its investment in the AIF, including for reasons that such information could impact an investor’s ability to exercise its rights in relation to its investment, or otherwise prejudice the interests of one or more investors in the AIF.

Box 101

EFAMA understands that the definition of “material change” shall represent a benchmark for triggering additional information duties not only in relation to the annual report, but also in terms of periodic disclosure to investors as suggested in Box 107 and 108. However, the term “material change” is used in the Level 1 Directive also in another context and in particular with regard to relevant changes in the scope of the AIFM authorisation according to Art. 10. In this respect, however, “material changes” refer to the conditions for manager authorisation and especially, to the information provided in the authorisation process according to Art. 7. It would appear inappropriate to apply in this context the ESMA’s definition of “material changes” which is focused on the consideration of operating circumstances for a specific fund.

Therefore, EFAMA would be grateful for clarification that the proposed definition of “material changes” is relevant only to specific transparency requirements and without prejudice to other AIFMD provisions containing references to material changes.

‘Material change’ is currently defined as meaning “changes in information if there is a substantial likelihood that a reasonable investor, becoming aware of such information, would reconsider its investment in the AIF, including for reasons that such information could impact an investor’s ability to exercise its rights in relation to its investment, or otherwise prejudice the interests of one or more investors in the AIF.”

EFAMA proposes that this is changed simply to say: “changes in information if there is a substantial likelihood that a reasonable investor, becoming aware of such information, would reconsider its investment in the AIF.” The reason EFAMA recommends this change is that the concept of ‘material’ is well understood (e.g. IAS1) and is best left broad; listing specific items runs the risk of restricting the concept.

Box 102

General Principles for the Annual Report

1. An AIFM shall, for each EU AIF it manages and for each AIF it markets in the Union or a Member State territory only, make available an annual report in accordance with Article 22 (1) of Directive 2011/61/EU.
2. The accounting information contained in the annual report shall be prepared in accordance with the accounting standards applicable in the home Member State of the AIF, or, as the case may be, in accordance with the accounting standards of the third country where the AIF is established and with the accounting rules laid down in the AIF rules or instruments of incorporation.
3. Where there is a conflict of dissimilarity between the accounting standards and the accounting rules that may apply to an AIF, the accounting rules shall be followed to the extent that this is permitted by national law. AIFM shall ensure that the accounting rules adopted provide investors with relevant and timely information with the most appropriate content and in the most appropriate format. In particular, where applicable accounting standards require consolidation of portfolio companies following an AIF acquiring control of a non-listed company or issuer under Article 26(1) of Directive 2011/61/EU, AIFs may be exempted from such requirements where specified in their accounting rules and where permitted under national law.
4. All information provided in the annual report, including that specified in Box 104 (Primary Financial Statements required under Article 22 (2) (a) and (b) of Directive 2011/61/EU), Box 105 (Contents and Format of the Report on Activities for the Financial Year) and Box 106 (Content and Format of Remuneration Disclosure) shall be presented in a manner that provides materially relevant, reliable, comparable and clear information. AIFM shall ensure as far as reasonably possible that the annual report contains the information investors may need in relation to particular AIF structures.

The Level 1 Directive is unclear as to whether the requirement to produce (as distinct from “to make available”) an annual report applies to the AIFM or the AIF. The ESMA Consultation Paper continues the ambiguity and we would recommend that it be resolved expressly by recognising that while, under level 1, Article 22, the AIFM is obliged to make available an annual report to investors in relation to the funds it manages, the preparation of several components of that report properly belong to the governing body of the AIF itself. Accordingly, we would submit that the AIFM may discharge itself of its obligations to make disclosures under Article 22, to the extent that disclosure obligations are met by the governing body of the AIF. EFAMA would recommend as well that, as under UCITS, where the governing body of the fund prepares the annual statements, the document containing them can be supplemented by the inclusion of an annual Investment Managers Report (a mechanic which is contemplated but not explored in Paragraph 25 on page 225 of the CP).

Regarding paragraphs 1 and 2 EFAMA notes that the information to be disclosed in the annual report includes, as set out in Article 22 (c) and (d), a report of the activities of the financial year; and any material changes in information listed in Article 23 during the financial year covered by the report. Article 23 sets out a long list of items, many of which would not be referred to in financial statements under most countries' laws or accounting standards (although may be included in Directors'/Investment Managers' reports). Much of the information is of a nature which would not be apparent to the Fund Administrator preparing the financial statements or potentially to the team of people within the AIFM that monitor and review them. Some reorganisation may be required therefore to accommodate these requirements. Responsibility for identifying such changes, determining materiality, drafting the text to be disclosed and providing this for inclusion in the financial statements would need to be established. It is proposed that these disclosures are part of the annual report document but not part of the financial statements. This avoids the need for an audit of the data, however, audit firms generally are required to review all information included in the annual report document to ensure it is consistent with the audited sections. Increased disclosures of this nature will inevitably increase the work required to prepare annual reports and for the audit, the size of the documents, with a corresponding increase in costs and further pressure on meeting regulatory deadlines for completion. In some cases, it may be that this type of information is included within Directors'/Investment Managers' reports; however, this is not always the case, and the information currently provided may not be the complete list as set out in Article 23.

Paragraph 3: EFAMA agrees with the first sentence; however, EFAMA suggests the deletion of the second sentence as it is not the role of the AIFM to determine what level of information is appropriate for an investor. Investors in AIFs should be completing their own detailed due diligence, focused on the areas that are important for them. EFAMA also notes the ESMA stance on consolidation and agrees that it would be expensive and may not fulfil the purpose for which it is intended.

Paragraph 4: The first sentence should be deleted (“All information provided in the annual report...shall be presented in a manner that provides materially relevant, reliable, comparable and clear information”) as this is duplicative. The second sentence states that “the AIFM shall ensure that as far as reasonably possible that the annual report contains the information investors may need in relation to particular AIF structures.” The AIFM will, in many circumstances, be restricted to a

greater or lesser extent with regard to its ability to dictate the format of the annual report, as it will need to comply with relevant accounting rules. Additionally, EFAM reiterates the point made above that it is not for the AIFM to speculate as to what information an investor may require.

Box 103

Reporting Material Changes for the Annual Report

1. In accordance with Article 22 (2)(d) of Directive 2011/61/EU AIFM shall, for each EU AIF it manages and for each AIF it markets in the Union or a Member State territory only, make available an annual report for each financial year or period, which shall contain material changes in relation to the information listed in Article 23 of that Directive for the applicable financial year or period.
2. For the purposes of complying with Article 22(2)(d) AIFM shall assess changes in the information listed in Article 23 of the Directive in accordance with the meaning of material change in Box 101 (Annual Report Definitions) and the definition of material in the accounting framework adopted by the AIF, as applicable.
3. Where applicable, such information shall be disclosed in line with the requirements of the accounting standards and rules adopted by the AIF. AIFM shall make additional disclosures when compliance with the specific requirements of the accounting standards and rules may be insufficient to enable investors to understand the impact of the change, or, where the information has already been provided to existing and potential investors, the AIFM may refer them to the medium in which or where such detailed information has been made available.
4. Where the information required to be disclosed is not covered by the accounting standards applicable to an AIF, or its rules, a description of the material change/s should be provided together with any potential or anticipated impact on the AIF and/or investors of the AIF. Where such information has already been provided to existing and potential investors, a summary may be provided with a reference to the medium in which or where that information has been made available.

Paragraph 3: EFAMA agrees with the first sentence. However, EFAMA suggests that the remainder of the paragraph is deleted; reason being that it is not the role of the AIFM to speculate as to what additional information may be relevant for an investor. Investors in AIFs should conduct their own due diligence and request additional information where required.

Paragraph 4: EFAMA suggests that the phrase “together with any potential or anticipated impact on the AIF and/or investors of the AIF” should be removed. The AIFM will not be in a position to know what the potential or anticipated impact of any change will be for its investors, as it is not privy to the particular circumstances of each investor.

EFAMA welcomes the last sentence of paragraph 4 and suggests clarifying that the medium by which the information is made available could be a website as foreseen in Box 23, point 3.

Box 104**Primary Financial Statements required under Article 22(2) (a) and (b) of Directive 2011/61/EU****Content and Format of the Balance Sheet (or Statement of Assets and Liabilities)**

1. In accordance with Article 22(2) (a) of Directive 2011/61/EU AIFM shall, for each EU AIF it manages and for each AIF it markets in the Union or Member State territory only, include a balance sheet or a statement of assets and liabilities within the annual report of the AIF. The balance sheet or statement of assets and liabilities shall contain at least the following elements and underlying line items, where applicable and where appropriate in relation to the type of AIF:
 - (a) "Assets" comprising the resources controlled by the AIF as a result of past events and from which future economic benefits are expected to flow to the AIF. Assets shall, where appropriate, be sub-classified according to the following line items:
 - (i) "Investments" including but not limited to debt and equity securities, real estate and property and derivatives. This line item will depend on the nature and structure of the AIF and its investment profile;
 - (ii) "Cash and cash equivalents" including, but not limited to, cash-in-hand, demand deposits and, where applicable, other short term liquid investments;
 - (iii) "Receivables" including, but not limited to amounts receivable in relation to dividends and interest, investment sold, amounts due from brokers and "prepayments" including amounts paid in relation to expenses of the AIF.
 - (b) "Liabilities" comprising present obligations of the AIF arising from past events, the settlement of which is expected to result in an outflow from the AIF of resources embodying economic benefits. Liabilities shall be sub-classified according to the following line items where this is appropriate according to AIF type:
 - (i) "Payables" including but not limited to amounts payable in relation to the purchase of investments or redemption of units or shares in the AIF and amounts due to brokers and "accrued expenses" including but not limited to liabilities for management fees, advisory fees, performance fees, interest and other expenses incurred in the normal course of operations of the AIF;
 - (ii) "Borrowings" including amounts payable to banks and other counterparties;
 - (iii) "Other liabilities" including but not limited to amounts due to counterparties for collateral on return of securities loaned, deferred income and dividends and distributions payable
 - (c) "Net Assets" representing the residual interest in the assets of the AIF after deducting all its liabilities.

2. The layout, nomenclature and terminology of line items should be consistent with the accounting standards applicable to or the rules adopted by the AIF, and comply with applicable legislation where the AIF is established. Such line items may be amended or extended by the AIFM in line with its obligations to ensure compliance with the above.
3. AIFM shall present additional line items, headings and subtotals in the balance sheet or statement of assets and liabilities when such presentation is relevant to and understanding of an AIF's financial position. Where relevant additional information shall be presented in the notes to the financial statements. The purpose of the notes is to provide narrative descriptions or disaggregation of items presented in the primary statements and information about items that do not qualify for recognition in these statements.
4. AIFM shall separately present each material class of similar items. Individual items, if material, should be disclosed. Materiality should be assessed under the requirements of the accounting framework adopted.
5. AIFM shall retain the presentation and classification of items in the balance sheet or statement of assets and liabilities, from one reporting or accounting period to the next unless it is apparent that another presentation or classification would be more appropriate to the AIFM's reporting obligation, or because an accounting standard has required a change in presentation

Content and Format of the Income and Expenditure Account

6. In accordance with Article 22(2) (b) of Directive 2011/61/EU AIFM shall, for each of the EU AIF it manages and for each AIF it markets in the Union or in a Member State territory only, make available an annual report for each financial year which shall contain an income and expenditure account for the financial year or, where applicable, the relevant financial period.
7. The income and expenditure account shall at least contain the following elements and underlying line items unless this information is not relevant to the type of AIF concerned:
 - (a) "Income" representing any increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in net assets other than those relating to contributions from investors. Income shall, where applicable and appropriate, be sub-classified according to the following line items:
 - (i) Investment income which can be further sub classified as follows:
 - i. "dividend income" relating to dividends on equity investments to which the AIF is entitled;
 - ii. "interest income" relating to interest on debt investments and cash to which the AIF is entitled;
 - iii. "rental income" relating to rental income from property investments to which the AIF is entitled;

- (ii) "Realised gains on investments" representing gains on the disposal of investments;
 - (iii) "Unrealised gains on investments" representing gains on the revaluation of investments; and
 - (iv) "Other income" including fee income from securities loaned and from miscellaneous sources
- (b) "Expenses" representing decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in net assets, other than those relating to distributions to investors. Expenses shall, where applicable and appropriate, be sub classified according to the following line items:
- (ii) "Investment advisory/management fees" representing contractual fees due to the advisor or AIFM as applicable; and
 - (iii) "Other expenses" including, but not limited to, administration fees, professional fees, custodian fees and interest. Individual items, if material in nature, should be disclosed separately.
- (b) "Net income/expenditure" representing the excess of income over expenditure or expenditure over income as applicable.
8. The layout, nomenclature and terminology of line items should be consistent with applicable accounting standards or rules adopted by the AIF, and comply with existing legislation of the jurisdiction where the AIF is established. As a result the above line items may be amended or extended by the AIFM in line with its obligations to ensure compliance.
 9. AIFM shall present additional line items, heading and subtotals in the income and expenditure account when such presentation is materially relevant to an understanding of an AIF's financial performance. Such additional information shall be presented in the notes to the financial statements. The purpose of these notes is to provide narrative descriptions or disaggregated items in the primary statements, as well as information about items that do not qualify for recognition in these statements.
 10. AIFM shall separately present each material class of similar items. Individual items, if material, shall be disclosed. Materiality shall be assessed under the requirements of the accounting framework adopted.
 11. AIFM shall recognize all items of income and expense in a given period in the income and expenditure account unless an accounting standard adopted by the AIF requires or permits otherwise.
 12. AIFM shall retain the presentation and classification of items in the income and expenditure account from one period to the next unless it is apparent that another presentation or classification would be or has become more appropriate, or an accounting standard requires a change in the presentation of these items.

Box 104

Generally, there is a significant amount of text related to the standard and form of the financial statements. By and large, however, this seems to retain the status quo by permitting the AIF to report under the accounting standards and rules of its country of establishment or as set out in the prospectus. EFAMA is therefore broadly supportive of the approach set out.

As regards the content of the income and expenditure account, EFAMA opposes the suggestion in Paragraph 7 (a) (iii) of Box 104 to present “unrealised gains on investments” as part of the income and expenditure account. This runs counter to the established reporting practice in many countries. EFAMA also notes that the UCITS regulations do not require this.

Box 105**Content and Format of the Report on Activities for the Financial Year**

1. In accordance with Article 22(2)(c) of Directive 2011/61/EU AIFM shall, for each of the EU AIF it manages and for each AIF it markets in the Union or in a member state territory only, make available a report on the activities of the financial year, or, where applicable, the activities of the relevant financial period within the annual report, which shall contain at least the following elements:
 - (a) An overview of investment activities during the year or period, and an overview of the AIF's portfolio at year-end or period end;
 - (b) An overview of AIF performance over the year or period; and
 - (c) Material changes in the information listed in Article 23 of the Directive not already presented in the financial statements.
2. The report shall include a fair and balanced review of the activities and performance of the AIF, containing also a description of the principal risks and investment or economic uncertainties that the AIF may face.
3. To the extent necessary for an understanding of the AIF's investment activities or its performance, the analysis shall include both financial and, where applicable according to the AIF type, non-financial key performance indicators relevant to that AIF.
4. The information provided in the report should be consistent with national rules where the AIF is established.

Box 105

EFAMA welcomes the clarification of the second sentence of point 24 of the explanatory text as well as point 25. EFAMA suggests including these sentences in Box 105.

EFAMA also recommends clarifying that if the AIF discloses conflicts of interest in its management report (as usually required by national rules/laws), it would satisfy the obligations foreseen under Box 23 (Paragraph 2 and 3) as well as Paragraph 6 of Box 106.

Paragraph 2: EFAMA recommends that the phrase “containing also a description of the principal risks and investment or economic uncertainties that the AIF may face” should be deleted, given that there will already be sufficient disclosures made in accordance with Article 23 of the Directive.

Paragraph 3: EFAMA recommends that this paragraph be deleted. This is because Article 23 already requires the disclosure of investment strategies, objectives, and other features and also any material changes to those features. EFAMA also suggests that it is not appropriate to include a set of additional performance indicators as it is not the role of the AIFM/ Directors to speculate as to what additional information may be helpful to investors or to judge their own performance.

Box 105 would then read as follows:

“Box 105

Content and Format of the Report on Activities for the Financial Year

*1. In accordance with Article 22(2) (c) of Directive 2011/61/EU AIFM shall, for each of the EU AIF it manages and for each AIF it markets in the Union or in a member state territory only, make available a report on the activities of the financial year, or, where applicable, the activities of the relevant financial period within the annual report **(which may be in the form of the Directors or Investment Managers' Report)**, which shall contain at least the following elements:*

- a) an overview of investment activities during the year or period, and an overview of the AIF's portfolio at year-end or period end;*
- b) an overview of AIF performance over the year or period;*
- c) material changes in the information listed in Article 23 of the Directive not already presented in the financial statements.*
- d) **conflicts of interest pursuant to Article 14 (2) of the Directive and***
- e) **remuneration disclosure as required under Box 106 (when appropriate).***

*2. The report shall include a fair and balanced review of the activities and performance of the AIF. **It should not disclose proprietary information on portfolio companies.***

3. The information provided in the report should be consistent with national rules where the AIF is established.”

Q63: Do you agree with the approach in relation to the format and content of the financial statements and the annual report? Will this cause issues for particular GAAPs?

See responses above regarding each box.

Box 106

Content and Format of Remuneration Disclosure

1. In accordance with Article 22(2)(e) of Directive 2011/61/EU AIFM shall, for each EU AIF it manages and for each AIF it markets in the Union or in a Member State territory only, disclose within the annual report of the AIF concerned the total amount of remuneration for the financial year, split into fixed and variable components.
2. AIFM shall specify whether the total remuneration disclosed in the AIF's Annual Report relates to:
 - (a) The total remuneration of the entire staff of the AIFM; or
 - (b) The total remuneration of those staff of the AIFM who in part or in full are involved in the activities of the AIF; or
 - (c) The proportion of the total remuneration of the staff of the AIFM attributable to the AIF.
3. Where this information is disclosed at the level of the AIF, an allocation or breakdown should be provided in relation to each AIF, insofar as this information exists or is readily available. As part of this disclosure, the AIFM should include a description of how the allocation or breakdown has been provided.
4. In relation to the requirements of Article 22(2)(f) of Directive 2011/61/EU aggregated amounts broken down by senior management and those members of staff whose professional activities have a material impact on the risk profile of the AIF shall be disclosed unless any such disclosure would breach the requirements of Directive 95/46/EC or other applicable legislation.
5. AIFMs shall provide general information relating to the financial and non-financial criteria of the remuneration policies and practices for relevant categories of staff to enable investors to assess the incentives created.
6. In accordance with the principles set out in Annex II (Remuneration Policy) of Directive 2011/61/EU AIFMs shall disclose at least the information necessary to provide an understanding of the risk profile of the AIF and the measures it adopts to avoid or manage conflicts of interest.

Q64: In general, do you agree with the approach presented by ESMA in relation to remuneration? Will this cause issues for any particular types of AIF and how much cost is it likely to add to the annual report process?

EFAMA considers that the remuneration disclosures should be subject to similar exemptions as are available to firms under Directive 2006/48/EC, which effectively allows information which is immaterial, confidential or proprietary to not be disclosed. The implementation of similar exemptions would ensure a level playing field across all firms subject to remuneration disclosures, which was one of the original objectives of the G20 when remuneration proposals were first tabled.

In our opinion, the proportionality principle is a key point to define the general framework of the remuneration policies for AIFM. It implies that each management company has a great flexibility to set up all the components of its remuneration policy, in accordance with the general principles established for the sector. In this respect, we would like to highlight one of the strong differences between the asset management industry and other financial activities: by nature, a management company does not take any risks affecting its own balance sheet or its assets.

EFAMA supports the fact that it is for the AIFM to determine whether to provide the disclosures at the level of the AIF or the AIFM. This should provide sufficient flexibility for AIFMs to be able to implement a solution which reflects the nature, scale and complexity of the AIFM and consequently results in a proportionate application of the obligations.

EFAMA would like to draw ESMA's attention to the fact that when AIF are incorporated as a separate legal entity, those responsible for the financial statements of the AIF will be those in charge of the corporate governance of the AIF. They may differ from the management of the AIFM. In this case, there are likely not to have a direct access to the AIFM records and thus not to be in a position to take responsibility and ownership for such disclosures. Moreover, the auditor of the AIF may not have direct access to the books of the AIFM in order to audit such disclosure.

In the case of umbrella funds it is not clear whether the remuneration disclosures should be at sub-fund or umbrella level.

VIII.II. Possible Implementing Measures on Disclosure to Investors

As a general concern regarding disclosure to investors EFAMA draws ESMA's attention to the fact that many funds caught by the AIFMD are nationally regulated retail investment funds. The distribution model of these products typically means that the AIFM does not have direct contact with the end investors but only with the distributors. This fact should be taken into consideration when finalising the disclosure requirements. The use of websites as a way to provide disclosure should be facilitated as much as possible.

Box 107

Periodic Disclosure to Investors

Percentage of Assets Subject to Special Arrangements

1. For the purposes of Article 23(4) (a) of Directive 2011/61/EU the percentage of assets subject to special arrangements as defined in Box 31 (Liquidity Management Definitions) shall be calculated as the net value of those assets subject to special arrangements, divided by the net asset value of the AIF concerned.
2. This information shall be disclosed as part of the AIF's periodic reporting to investors, as required by the AIF rules or instruments of incorporation, prospectus and offering documents and, at a minimum, in the annual report of the AIF.

3. The required disclosure shall contain an overview of any special arrangements including the valuation methodology applied to the special arrangements and how management and performance fees apply to these assets.

New arrangements for managing the liquidity of the AIF

4. AIFMs shall disclose whenever they make any material changes, in accordance with the measures in Box 101 (Annual Report Definitions) to the liquidity management policies and procedures adopted for monitoring the liquidity risk of the AIF and ensuring that the liquidity profile of the investments of each AIF aligns with the AIFM's obligations in relation to liquidity management. AIFMs shall immediately notify investors where they activate gates, side pockets or similar special arrangements or where they decide to suspend redemptions.
5. The required disclosure shall contain an overview of the changes to the arrangements relating to liquidity, whether special arrangements or other arrangements, including where relevant the terms under which redemption is permitted and the circumstances defining when management discretion shall apply.

Risk profile of the AIF

6. AIFMs shall disclose the current risk profile of each AIF as part of their obligations relating to periodic disclosure to investors as required by the AIF rules or instruments of incorporation, prospectus and offering documents and, at a minimum, in the annual report of the AIF.

OPTION 1

7. AIFM shall ensure that periodic disclosures shall contain an assessment of the exposure of the AIF's portfolio to the most relevant risks to which the AIF is, or could be, exposed, including where risk limits set by the AIFM have been, or are likely to be, exceeded. Where these risk limits have been exceeded the disclosure should additionally include a description of the circumstances and, where applicable, the remedial measures taken.
- [or]

OPTION 2

3. Periodic disclosure by AIFM shall contain all of the following:
 - (a) Identification of the most relevant risks to which the AIF is or could be exposed;
 - (b) Measures used by the AIFM to assess any sensitivity in the AIF portfolio to the most relevant risks to which the AIF is, or could be, exposed; and
 - (c) The results of any relevant stress tests, or an indication as to whether, in the opinion of the AIFM, the exposure is likely to increase, is stable or is decreasing and within, near to, or exceeding risk limits set by the AIFM. Where risk limits have been exceeded the disclosure shall additionally include a description of the circumstances and, where applicable, the remedial measures taken.

Risk management systems employed by the AIFM

4. The main features of the risk management systems employed by the AIFM to manage the most relevant risks to which each AIF it manages is or may be potentially exposed, shall be made available to investors prior to investment
5. AIFMs shall provide an overview of the procedures employed to assess the most relevant risks to which each AIF it manages is exposed and the techniques, tools and arrangements it employs to manage these risks.
6. Thereafter disclosure obligations shall be triggered where there are material changes in accordance with the definition in Box 101 (Annual Report Definitions). Such disclosure shall include information relating to the change and its anticipated impact on the AIF and its investors.

Box 107*Percentage of assets subject to special arrangements*

When a prospectus is drafted, it is difficult to determine the exact percentage of assets that will be subject to "special arrangements" (i.e. side pockets, gates, lockups) as this would not be known until the point at which these arrangements are effectively exercised by the manager of the fund. In short, the manager of the fund cannot know in advance the exact percentage of assets that it will need to side pocket, gate, or lock in. The fund manager can only rely on an anticipated or maximum level of assets disclosed in the prospectus/offering memorandum. Periodic reporting, however, could theoretically capture the level of assets subject to special arrangements at a snapshot in time.

The way in which "special arrangements" are used varies across the different fund types and sufficient flexibility should be included in the Level 2 text to allow for this flexibility and so as not to stifle innovation in this area.

Furthermore, EFAMA believes that funds with no periodical redemption rights should only be required to disclose information relating to Paragraphs 1, 2 and 3 in its first disclosure to investors and not be required to do so on a periodical basis.

Risk profile of the AIF

EFAMA strongly favours the use of Option 1 as this more easily accommodates a variety of different types of fund. The primary difference between Options 1 and 2 is that Option 2 is proscriptive in stating "measures" and "relevant stress tests", etc. must be disclosed; the definition (and hence relevance) of stress tests is subjective and varies from AIFM to AIFM; what is relevant also varies from asset class to asset class. Option 2 is therefore too prescriptive and not necessarily relevant for all alternative sectors. Option 1's "exposure to ... the most relevant risks" covers the same ground, but leaves the AIFM free to present the most relevant measures. It also is the option which maintains a better degree of flexibility to permit compliance by non-EU AIFM of non-EU AIF.

Risk management systems employed by the AIFM

EFAMA considers the required information in the second part of paragraph 10 to be onerous (as the description of the techniques, tools and arrangements may lead to very long disclosure, in particular for umbrella structures as tools and techniques may differ from one sub-fund to the other) and not necessarily of an immediate interest to all investors. We suggest therefore the second part of the paragraph to be amended as follows, i.e.: *“and the AIFMs shall make available to investors on request the techniques, tools and arrangements it employs to manage these risks”*.

Box 108**Regular Disclosure to Investors**

1. Whenever material changes occur in relation to the elements in Article 23(5)(a) of Directive 2011/61/EU, a disclosure requirement shall be triggered for the AIFM concerned. Such disclosure should contain the following information, as appropriate to the type of AIF:
 - (a) The original and revised maximum leverage level in accordance with the methods of calculation of exposure of AIF in Box 95 (Gross Method of Calculating the Exposure of an AIF) or, where applicable, Box 97 (Advanced Method of Calculating the Exposure of an AIF). The level of leverage shall be calculated in each case as the relevant exposure divided by the net asset value of the AIF;
 - (b) The nature of the rights granted for the re-use of collateral;
 - (c) The nature of guarantees granted; and
 - (d) Details of changes in any service providers disclosed in accordance with Article 23(1)(d) which relates to paragraphs (a) to (c) above.
2. The information shall be presented in a clear and understandable way.
3. The information referred to in points (a) to (d) in Paragraph 1 shall be provided in a timely manner.
4. The total amount of leverage employed by an AIFM, on behalf of an AIF, in accordance with the methods of calculation of leverage set out in paragraph 1, shall be disclosed as part of an AIF's periodic reporting to investors as required under the AIF rules or instruments of incorporation, prospectus and offering documents and shall, at a minimum, be disclosed in the AIF's annual report.
5. The disclosure referred to in Paragraph 4 shall include a description of the leverage measures or ratios and their appropriateness when considered against the investment strategy of the AIF, as well as the maximum levels of leverage to which the AIF has been made subject by the AIFM.

Box 108

EFAMA is concerned that the technical advice proposals place too much importance on leverage, and in particular gross leverage, as a useful statistic for regulators and investors. Gross leverage does not measure, and is poorly correlated with, the risk of a portfolio for investors, or the systemic risk that an AIF may pose.

EFAMA supports in general the proposed approach requiring timely disclosure only in respect of "material changes" to the maximum leverage level and permitting inclusion of information on the actual total amount of leverage in the AIF annual report. EFAMA is however concerned that setting a maximum level of leverage that must be complied with at all times may be unhelpful for regulators and investors as it allows no flexibility for unusual market conditions. The lack of flexibility would lead to AIFMs setting arbitrarily high limits on gross leverage to avoid ever breaching it. This is not helpful for regulators in terms of assessing risk posed to markets or prospective investors in terms of assessing suitability.

EFAMA notes that in broad terms the content of Box 108 is in line with UCITS regulations which will facilitate the reporting for AIFMs who also manage UCITS. There is one exception, however, whereby the Directive refers to the disclosure of the total amount of leverage, whereas for UCITS reference is made to disclosure of the "leverage level", whereby the information may be based on the average level of the leverage effects observed (and followed) during a period. EFAMA suggests also to making reference to the possibility to calculate the total leverage on the basis of the average level of the leverage effects observed (and followed) during a period.

Q65: Does ESMA's proposed approach in relation to the disclosure of 1) new arrangements for managing liquidity and 2) the risk profile impose additional liability obligations on the AIFM?

Disclosure of new arrangements may impose additional liability (including, but not limited, to conflicts of interest, insider trading, fraud and breach of fiduciary duty) where certain investors are informed of certain special arrangements that do not concern them as in the case of liquidating SPVs or side pockets. Accordingly "investor" should be defined and intended for all purposes as "investor concerned by the special arrangement".

Q66: Do you agree with ESMA's proposed definition of special arrangements? What would this not capture?

Please refer to our comments on Box 31 above.

Q67: Which option for periodic disclosure of risk profile under Box 107 do you support? Please provide reasons for your view.

EFAMA strongly favors the use of Option 1 as this more easily accommodates a variety of different types of fund. The primary difference between Options 1 and 2 is that Option 2 is proscriptive in stating “measures” and “relevant stress tests”, etc. must be disclosed; the definition (and hence relevance) of stress tests is subjective and varies from AIFM to AIFM; what is relevant also varies from asset class to asset class. Option 2 is therefore too prescriptive and not necessarily relevant for all alternative sectors. Option 1’s “exposure to ... the most relevant risks” covers the same ground, but leaves the AIFM free to present the most relevant measures. It also is the option which maintains a better degree of flexibility to permit compliance by non-EU AIFM of non-EU AIF.

Q68: Do you think ESMA should be more specific on the how the risk management system should be disclosed to investors? If yes, please provide suggestions.

Given the wide variety of types and natures of AIF falling under the scope of the AIFMD EFAMA does not suggest ESMA to be more specific on how the risk management system should be disclosed to investors, as it would then be more difficult to achieve a “one size fits all” disclosure requirement. EFAMA suggests however that the disclosure of the risk management system be subject to the general principle of proportionality and this should take into account the different types of AIF.

VIII.III. Possible Implementing Measures on Reporting to Competent Authorities

Box 109

Format and Content of Reporting to Competent Authorities

1. In accordance with the requirements in Article 3(3)(d) or Article 24(1) of Directive 2011/61/EU an AIFM shall report on a quarterly basis to the competent authorities of its home Member State the following information:
 - (a) The main types of instruments in which it is trading, including a break-down of financial instruments and other assets, taking into account the AIF’s investment strategy and its geographical and sector investment focus;
 - (b) The markets of which it is a member or where it actively trades;
 - (c) The diversification of the AIF’s portfolio including, but not limited to, its principal exposures and most important concentrations.
2. The information required under paragraph 1 shall be provided no later than one month after the end of the relevant period;
3. In accordance with the requirements in Article 24(2) of Directive 2011/61/EU, an AIFM shall provide for each EU AIF it manages and for each of the AIF it markets in the Union, the

following information to the competent authorities of its home Member State:

- (a) The percentage of the AIF's assets which are subject to special arrangements arising from their illiquid nature in accordance with Article 23(4)(a) of Directive 2011/61/EU and in accordance with Box 31 (Liquidity Management Definitions);
 - (b) Any new arrangements to manage the liquidity of the AIF;
 - (c) A description of the risk management systems employed by the AIFM to manage market risk, liquidity risk, counterparty risk and other risks including operation risks;
 - (d) The current risk profile of the AIF including:
 - (i) The market risk profile of the investments of the AIF including the expected return and volatility of the AIF in normal market conditions;
 - (ii) The liquidity profile of the investments of the AIF including the liquidity profile of the AIF's assets, the profile of redemption terms and the terms of financing provided by counterparties to the AIF;
 - (e) Information on the main categories of assets in which the AIF invested including the corresponding short market value and long market value, the turnover and performance during the reporting period; and
 - (f) The results of periodic stress tests, under normal and exceptional circumstances, to the extent that AIFM are subject to the requirements of Article 15(3)(b) and Article 16(1) second subparagraph of Directive 2011/61/EU.
4. Where an AIFM is required to report under paragraph 3 it shall provide the information required on a quarterly basis. The information shall be provided no later than one month after the end of the relevant period.
 5. As an exception to paragraph 4, a competent authority may deem it appropriate to require an AIFM to report all or part of the information on a more frequent basis.
 6. AIFMs managing one or more AIFs which they have assessed to be employing leverage on a substantial basis in accordance with Box 110 (Use of Leverage on a Substantial Basis), shall provide the information required under Article 24(4) subparagraph of Directive 2011/61/EU at the same time as that required under paragraph 3.
 7. AIFMs shall provide the information specified under paragraphs 1, 3 and 6 in accordance with the pro forma reporting template or, for information not specified in that template, in a manner determined by the competent authorities of the home Member State. However, where an AIFM is required to report information on a more frequent basis in accordance with paragraph 5, the competent authority of the home Member State may require and AIFM to provide all or part of the information specified in the pro-forma reporting template in a different format.
 8. In accordance with Article 42(1)(a) of Directive 2011/61/EU, for non-EU AIFMs any reference to

the competent authorities of the home Member State shall mean the competent authority of the Member State where the AIF is marketed.

Box 109

EFAMA is very concerned about the suggested reporting requirements to competent authorities which are extremely onerous. Our members are concerned about the volume of information and potential costs, particularly if this is required quarterly.

EFAMA strongly recommends that rather than quarterly reporting, reporting should be on an annual basis for all or at least most AIFs. The reporting deadline should be in line with that required for the annual report.

The reporting requirements largely exceed what is necessary to assess and manage systemic risks. The requirements are too detailed and reporting is required too frequently for majority of funds. A distinction should be drawn between hedge funds and other kinds of funds, between large funds with potential systemic implications and smaller funds.

ESMA proposes quarterly reporting for all AIFs on the basis of the extensive template provided in Annex V. Information on particulars of risk and liquidity management may be even required in a more frequent cycle by the competent authority of the AIFM. Many asset managers would then face the challenge to prepare quarterly reports for several dozens, or even hundreds, of AIFs. This task will involve high operational costs on a permanent basis as it will not be possible to fully automate the computation of the reporting items according to the reporting template in Annex V. Such significant costs must be considered a continuing factor to drag down the fund performance to the detriment of AIF investors. Our members estimate that the cost of implementing a quarterly reporting would be at least from half a person to one person a year.

EFAMA is fully aware of the fact that reporting to authorities is considered one of the cornerstones of the Directive for detecting potential systemic risks. However, in defining the applicable requirements ESMA must pay due regard to the proportionality principle as a general guideline for its recommendations. Measures taken for identifying systemic risk must still be commensurate to the probability of materialization of such risks in certain vehicles. It is incontestable that the potential for systemic risk in funds applying speculative trading strategies and an unlimited level of leverage is much higher than in funds with a conservative approach to leverage and clear rules on portfolio composition.

As the layout and content of the ESMA reporting template derives from the IOSCO work on reporting for hedge funds, most of the information required would not be relevant for other alternative funds. Moreover, it is important to bear in mind that, given the broad definition of an AIF as per the Directive, a significant proportion of AIFs will not pursue alternative strategies at all but will be plain-vanilla funds investing only in long position over listed securities that had not opted for the UCITS status. Most of the disclosure require under the pro-forma are not relevant for these unleveraged

funds. Imposing these onerous reporting requirements to types of funds when not relevant is not in line with the “proportionality” principle.

Hence, we believe that the reporting requirements should ensure a proper differentiation between the types of AIF having regard to the corresponding probability of systemic risk. In EFAMA's opinion, such differentiation could be performed according to the predominant investment strategy which shall be specified for each AIF as the first item in the reporting template.

ESMA itself has categorized the AIF investment strategies depending on the AIF type in the sample guidance for reporting included in the consultation paper. On the basis of these categories, the reporting duties should be attached first and foremost to AIFs following hedge fund strategies (column 1) and to funds of hedge funds (column 3). The remaining types of AIF should be granted significant reliefs in their reporting obligations towards authorities. This should pertain both to the “Other Funds” category which comprises UCITS-like long-only funds and to “Private Equity Funds” displaying a static risk profile which certainly does not justify more frequent reporting. Real estate funds the risk profile of which bears similarities with private equity investments should also be included in the “Other Fund” section.

EFAMA proposes to define the UCITS-like AIFs the following way: The AIF invests in assets which may be either eligible or equivalent according to the UCITS Directive and considers the risk spreading rules as well as the investment limits as provided in UCITS including the limits on leverage or such rules and limits which can be considered as equivalent to UCITS. This definition includes individual modifications according to national law.

EFAMA would indeed welcome a “decision tree” approach whereby the responses given to initial questions on the strategy, leverage and size would trigger a tailored report. EFAMA notes from Annex V that only section 1 is applicable to all AIFMs; Sections 2 and 3 only apply to an AIF ‘which is of a material size’. Much will depend therefore on which AIFs fall in this category. We think it critical that these sections need only be completed for AIFs which are of such a size as to pose systemic risk. There is no point in competent authorities being overloaded with information – they will not be able to assess and utilize this volume of information effectively.

This approach would reconcile the legitimate concern of ESMA to establish the tools for an adequate supervision, the flexibility requested by the Commission and the efficiency objective of the industry. In EFAMA's view it is highly disproportionate to expect the same reporting quality from highly leveraged hedge funds and traditional real estate or long-only funds for the purpose of identifying systemic risk. This view appears to be backed by the new strategy of the EU Commission to exempt certain vehicles from the AIFMD scope of application and to submit them to a “lighter regulatory regime” precisely for the reason of their negligible relevance in systemic terms, see The Commission consultation on Venture Capital funds.

Detailed EFAMA comments on Annex 5

- Page 422, section 1 : under the proposed format, the funds that do not pursue an alternative strategy, which can be very numerous as mentioned above, will be mingled in an “other funds” category including as well infrastructure and commodity funds as well as an “other” category. EFAMA wonders whether it makes sense to mix funds with such different profiles.
- Page 423 and 424, individual exposures per categories of instruments: EFAMA believes that a category of cash and cash equivalent (for money market funds) should be added as well as a category “other assets” under point c) real assets (for assets such as art, wine,...).
- Page 423: EFAMA wonders why the G10 bonds are split per maturity and not the Non-G10 bonds (what is the purpose of this information?). EFAMA would also suggest considering the distinction between “investment grade” and “non-investment grade” similarly as for the corporate bonds, as EFAMA do not understand the relevance of the distinction between G-10 and Non G-10.
- Page 425: typical deal size: the type of information required should be clarified.
- Page 425, point 4, value of turnover: formula for calculating turnover should be defined to order to allow consistency in the reporting. Turnover on money market instruments and derivative is usually not a relevant information as it is a direct consequence of the roll forward of short term positions. EFAMA would then suggest to remove these from the reporting.
- Page 426, section 1, 4, c): EFAMA assumes that there is a typo and this should read other assets rather than other funds?
- Page 426, section 2, point 6: if the fund is distributed through intermediaries (for instance, retail funds, feeders, funds of funds...), this information will not necessarily be accessible and the AIFM might not be in a position to report.
- Page 427, section 2: AIFM should not be required to disclose “expected” return and risk profiles to regulators. Such disclosure would be pure conjecture.
- Page 427, section 3, point 9: the category “infrastructure fund” mentioned here is not included as a category per say under question 1. As this section focuses on typical “hedge fund” risks, all fund categories other than hedge funds (for instance the unleveraged funds invested in listed securities as mentioned above) should be exempted from this section. Indeed, expected return cannot be assessed upfront for traditional funds taking long position on the markets as the return will largely derive from the beta.
- Page 429, section c) liquidity profile is not relevant for closed-end funds. They should be exempted from this reporting.
- Page 431, 18, i): if the fund is distributed through intermediaries (for instance, retail funds, funds sold through feeders, funds of funds, structures...), this information will not necessarily be accessible and the AIFM might not be in a position to report.
- Page 434: the category “other funds of funds” will mix up alternative and non-alternative strategies. Will this information be useful?

Q69: Do you agree with the proposed frequency of disclosure? If not, please provide alternative suggestions.

As discussed above regarding Box 109, EFAMA strongly recommends that rather than quarterly reporting, reporting should be on an annual basis for all or at least most AIFs and then the reporting deadline should be in line with that required for the annual report.

Q70: What costs do you expect completion of the reporting template to incur, both initially and on an ongoing basis? Please provide a detailed analysis of cost and other implications for different sizes and types of fund.

According to EFAMA's evaluation, reporting upon the template proposed in Annex V would incur very high initial and ongoing costs. The high level of ongoing expenses must be assumed due to the suggestion to require quarterly reports for each and every AIF and the necessity to perform manual computation of certain reporting items.

Costs will vary significantly depending on the nature of strategies, the number of funds, their domicile and the number of different systems from which the information will have to be aggregated. Whilst difficult to precisely quantify within such short timeframe, costs seems disproportionate for the closed-end structures and small unleveraged funds invested in listed securities where the risks are limited as these do not present systemic risks. EFAMA urges ESMA to consider proportionality principle as regards to the information to be reported and to carefully balance the cost to produce the information versus how this information will be used in order to identify systemic risks as these costs could damage the competitiveness of the European AIF versus the rest of the world.

Q71: Do you agree with the proposed reporting deadline i.e. information to be provided to the competent authorities one month after the end of the reporting period?

EFAMA strongly recommends that rather than quarterly reporting, reporting should be on an annual basis for all or at least most AIFs and then the reporting deadline should be in line with that required for the annual report.

Box 110

Use of leverage on a "Substantial Basis"

1. In order to comply with the requirements in Article 24(4) of Directive 2011/61/EU and AIFM employing leverage shall make an assessment for each EU AIF it manages and for each of the AIF it markets in the Union as to whether leverage is being employed on a substantial basis in accordance with the methods of calculation of exposure of AIF in Box 95 (Gross Method of Calculating the Exposure of the AIF) Box 96 (Commitment Method of Calculating the Exposure

of an AIF) and, where applicable, Box 97 (Advanced Method of Calculating the Exposure of an AIF).

2. The assessment of whether leverage is employed on a substantial basis shall have regard to the following non exhaustive considerations:
 - (a) The type of AIF under management including its nature, scale and complexity;
 - (b) The investment strategy of the AIFM in relation to the AIF concerned;
 - (c) The market conditions in which the AIF and the AIFM operate;
 - (d) Whether the exposures of an AIF arising through the use of leverage by an AIFM could constitute an important source of market risk, liquidity risk or counterparty risk to accredit institution or other systemically relevant institutions;
 - (e) Whether the degree of leverage employed by an AIF could contribute to the build up of systemic risk in the financial system or risk of disorderly markets.
3. AIFM shall monitor, on an ongoing basis, their use of leverage and, where there is a material change shall carry out a new assessment.
4. The competent authorities of the home Member State of the AIFM shall consider the information collected under Article 24 in their determination of whether leverage is employed on a substantial basis and may review the assessment made by the AIFM having regard to the factors considered in accordance with paragraph 2. Where the competent authority considers that the AIFM is employing leverage on a substantial basis the additional reporting obligations in accordance with Article 24(4) Directive 2011/61/EU and Paragraph 7 of Box 109 (Format and Content of Reporting to Competent Authorities) shall apply to such AIFM.
5. AIFM shall notify the competent authorities of their home Member State of the outcome of their assessment in paragraph 1, and shall provide a copy of the assessment to the competent authorities upon request.

Q72: Does ESMA's proposed advice in relation to the assessment of whether leverage is employed on a substantial basis provide sufficient clarity to AIFMs to enable them to prepare such an assessment?

Paragraph 1:

In EFAMA's view the calculation should be done only according to one method, at the choice of the AIFM (see comments on Box 93).

Paragraphs 2, 4 and 5:

In EFAMA's view the criteria set out in order to assess whether leverage is employed on a substantial basis are highly judgmental and subjective and could be interpreted very differently by competent authorities and AIFMs. We therefore wonder whether the proposed definition will lead to a

consistent approach to leverage. This is particularly the case as the list is noted as being “non-exhaustive”.

Moreover, we believe that to perform the assessment required under the points d) to f), the AIFM would have to consider consolidated information on the markets and information about investees/counterparties that are not under its control or accessible to it but rather only to the regulators. These points create an obligation that is difficult to discharge effectively.

EFAMA therefore suggests that further clarity and/or objective criteria are included here and also that our previous comments are borne in mind in determining those criteria.

EFAMA also notes that it is extremely unlikely that an AIFM would knowingly pursue a strategy which, per item (e), “could contribute to the aggravation or downward spiral in the prices of financial instruments or other assets in a manner which threatens the viability of these prices”.