European Securities and Markets Authority
103 Rue de Grenelle
75007 Paris
France

Submitted only online at: www.esma.europa.eu

13 September 2011

Dear Sirs

**ESMA's draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive (ESMA 2011/209)**

**Response of the British Property Federation**

**About the British Property Federation**

The British Property Federation is a membership organisation devoted to representing the interests of all those involved in real property ownership and investment in the United Kingdom. We aim to create the conditions in which the UK property industry can grow and thrive, for the benefit of our members and of the economy as a whole. Our membership includes the biggest companies in the property industry - property developers and owners, institutions, fund managers, investment banks and professional organisations that support the industry. Most of our members are headquartered in the UK but many of them invest in property on a global or pan-European basis.

The British Property Federation is a member of the European Property Federation and works closely with other real estate organisations in Europe, including INREV and EPRA on international issues relevant to property businesses.

Businesses which develop and invest in real estate are an integral part of the real economy, creating, improving and looking after the buildings in which people live, work and relax. Money spent by such businesses supports jobs in the construction and property services industries. Business productivity and Europeôs efforts to tackle climate change both depend on investment by property firms to improve our built environment.

Being firmly rooted in the real economy, real estate businesses are not a source of systemic risk. Systemic risk is the chance of an entire financial system failing and reflects the dangers that arise from interdependencies in markets and systems as opposed to isolated risks associated with individual firms or institutions. Real estate businesses do not exhibit the interconnections prevalent in, say, the banking system. Any loss on an individual property portfolio investment does not impose additional losses on other investments in the same fund portfolio (or on other funds), nor does it have a contagion or a ñdominoòeffect on other investments. Real estate businesses therefore do not pose a systemic risk.

**Executive summary**

We commend the impressive work done by ESMA in developing its first draft technical advice on such complex matters, many of them wholly new to the EU regulatory system, in such a tight timetable. We are also grateful for having had the opportunity to discuss some of our concerns with ESMA officials, including at the productive Open Hearing on 2 September. We are generally supportive of many of ESMAôs proposals. However, we have two broad but key concerns.

First, we believe that some of the implementing measures need to be **further and better tailored** to AIF which invest in land and buildings in order to make them workable. In particular, we are concerned that the structures typically used by UK private equity real estate funds (often investing across Europe) have not yet been fully taken into account in ESMAôs draft guidance to the Commission. This subsector, which is at least as large as the UKôs listed property sector, differs structurally from both from the listed property sector and from the institutional fund managers who we suspect have so far contributed more actively to ESMAôs work.

Second, we believe that further attention must be given to the position of internally-managed AIF. This is especially important because the property industry (both in the UK and internationally) includes many **property companies**, many of them listed, but many more privately owned. Whilst we do not believe that such property companies should, in general, fall to be treated as AIF for the purposes of the

Directive (or that ultimately they will be so treated), there continues to be some uncertainty about this. Whilst we appreciate that basic questions concerning the scope of the Directive are not the subject of the current consultation, we find it extremely difficult to apply ESMA's draft technical advice to such companies. We believe strongly that this is because they are not properly to be regarded as AIF. However, until the position is clarified (by ESMA or the European Commission or Member State competent authorities), it is incumbent upon us, and upon ESMA, to work towards technical standards which accommodate them.

We expand on these two concerns in the rest of this covering letter.

We set out our detailed responses in the Schedule. We have not sought to answer every question, but only those which we consider to be particularly relevant to our membership.

**Need for further and better tailoring to AIF which invest in land and buildings**

The following measures in particular require further tailoring.

- Depositaries
- Risk management and valuation (which we take together)
- Additional own funds and professional indemnity insurance

***Depositaries***

- **Many of our members' AIF invest in companies, JVs or other vehicles, as opposed to investing directly in land and buildings, so the categorisation of private shares or units as "other assets" is vital.** Neither private equity real estate AIF nor property companies typically invest directly into land and buildings (in other words, the AIF or the AIFM is not usually itself the owner named in the documents or register evidencing title to the land). Rather, they invest in often wholly owned subsidiary companies, joint ventures or other vehicles (such as unit trusts) which own the land and buildings. It is clear that these assets should not be treated as "financial instruments that should be held in custody" (and we support Option 2 in Box 78). It should also be made clearer that physical assets need only be held in custody by the depositary to the extent that they are financial instruments *title to which can be transferred by physical delivery* (i.e. bearer instruments or those issued in nominative form).

- **We believe it should be made clearer in the draft technical standards that the circumstances and extent to which the depositary must "look through" the assets of the AIF are very limited.** The depositary will of course need to recognise the fact that the companies and other vehicles in which the AIF has invested, or their subsidiaries, themselves hold underlying assets (in our case the title to real property). For example, it must in practice do so in order to discharge its obligation to have oversight of the valuation process (Article 21(9)(b)). However, it is vital that it be understood that the depositary is not required to *verify the ownership* of the underlying assets. If this were required in the context of real estate funds, then the depositary would be required to obtain an independent legal opinion on the quality of title. Such opinions would be duplicative of the work done by the AIFM in due diligence, very costly (in the order of tens of thousands of pounds per item) and inevitably subject to caveats, thus rendering the ultimate benefit of such an exercise questionable. In addition, where more than one AIF was invested in a company, it would make no sense for each depositary to be required to verify the title of the company to land and buildings owned by it: this would be entirely duplicative and it would ignore the reality that the company owns the asset and that each AIF has economic exposure to only a fraction of the asset. A look-through approach would also be inconsistent with the legal analysis applicable to depositaries of AIF or UCITS investing in the listed holding company of a large group (such as Vodafone Group PLC), where the depositary is responsible for the title to the shares in the PLC and not for verifying title to shares in its operating subsidiaries (such as Vodafone Essar in India) or for verifying the ownership of physical assets (such as mobile telephone masts).

- **Some of the discussion of cash accounts in the consultation paper needs to be revisited.** We commend the recognition by ESMA officials that there are inevitably a few errors in the explanatory text of the consultation paper which survived the editorial process. Some of them are significant, particularly those that relate to the treatment of cash accounts of the AIF. For example, the suggestion on p. 157, § 29 that cash is an example of "other assets" is incorrect (cash is a third category within Article 21) and there is a need to make it clear that cash accounts may be held on deposit (i.e. not segregated) with third party credit institutions and need not necessarily be maintained with the depositary. This must be addressed if the possibility of a non-bank depositary for certain closed-ended AIF is to be given effect, as

expressly contemplated by the Council and the Parliament in the Level 1 text in the final paragraph of Article 21(3).

- **The depositary's role in relation to "other assets" is one of oversight, and the depositary should not exercise ex ante control.** It is clear in the Level 1 text that the function of the depositary in relation to "other assets" (i.e. those which need not be held in custody) is one of oversight. This question has been settled and ESMA should not reopen any debate about it. We therefore strongly favour ESMA's proposals which properly reflect this (notably Option 1 in Box 81) and strongly reject both express suggestions in the consultation paper that the depositary might exercise ex ante control (e.g. p. 165, § 49) and proposals which come close to it in effect (e.g. Box 81, Option 2 - the proposal for "mirroring" of accounts). Failure to respect this distinction would be inconsistent with the Level 1 text and would result in the depositary having a level of control which could undermine the AIFM as the discretionary investment manager of the AIF. This would be totally contrary to the expectations of the AIF's sophisticated institutional investors who would have done extensive due diligence on and selected the AIFM, as opposed to the depositary. It was for all of these reasons that the political agreement at Level 1 was on an oversight function only. We disagree with ESMA's statement (on page 162, paragraph 43) that the provision of prior information to the depositary is feasible in the case of real estate AIF.

***Risk management, and independence of the valuation function***

- **We think ESMA should address the independence of the valuation function, as well as the independence of the risk management function.** We take these topics together because our concerns with them are related in a number of key aspects. We note that the European Commission is not required by the Directive specifically to develop technical standards relating to the functional independence of the internal valuation function (Article 18(4)(b)). However, we believe that it would be appropriate for ESMA to comment on it in the context of its technical advice on the procedures for the proper valuation of the assets and the calculation of NAV.

- **Where it is not proportionate for there to be functional and hierarchical separation of the risk management function, ESMA's suggested list of compensating controls needs to be revised.** We welcome the recognition (in Box 30) that it may not be possible for many AIFM to comply with the full-blown requirements for a functionally and hierarchically separate risk management function. However, we believe that ESMA needs to revise the list of safeguards set out in Box 30, § 3. The current suggestions are unworkable because they contemplate a separate group of people performing the risk management function. In particular, the proposal that risk managers should be compensated independently of the performance of the business is impossible to achieve in most current structures (large or small) and is disproportionate to any investor-protection concern. We suggest that the topic of remuneration is already addressed adequately in the Level 1 provisions on remuneration, and that there will be an opportunity to address this topic fully through ESMA's guidance on remuneration.

  We suggest that Box 30, § 3 should be revised to focus more explicitly on the effectiveness of the risk management function (where it is not functionally and hierarchically separated) and that, in the context of an AIFM investing in illiquid assets for the long-term, it should contemplate a combination of some or all of the following safeguards on a proportionate basis having regard to 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;
  (b) formal written investment and divestment proposals drawn up by explicit reference to applicable investment guidelines, and addressing risks relevant to each asset and the risk-profile of the portfolio as a whole;
  (c) decisions to be taken by committee, facilitating the internal challenge of ideas, with key points minuted;
  (d) compliance with Article 13 in relation to remuneration; and
  (e) compliance with Article 14 in relation to conflicts of interest.

- **Similar safeguards should evidence the effectiveness of the internal valuation function.** In addition, it should be expressly recognised that an internal valuation function may be particularly effective where the AIFM makes use of an independent third party valuation of the underlying land and buildings (regardless of whether or not the land and buildings are, strictly speaking, themselves the relevant assets). However, in relation to valuation, the most important consideration in relation to effectiveness is that fundamental valuation techniques and current market metrics are employed by the people best placed to use them (see below).

- **For real estate funds, risk management and valuation are bound up with proper performance of the portfolio management function: these functions are not easily separated and it would be counterproductive to separate them.** In considering our proposals, it must be recognised that for AIFM whose strategy is to invest in illiquid assets for the long-term, both the risk management and valuation functions are bound up in the investment decision-making process. They are not susceptible to separation in the way that, for example, the trading decisions of a hedge fund portfolio manager are subject to quantitative risk limits (of the sort contemplated in Box 29) imposed and monitored by a specialist professional. For example, when a real estate fund management firm considers whether to make a further investment into an existing asset to fund repairs, improvements or sustainability enhancements to the fabric of a building, the starting point for its decision is its expert assessment of the current value of its current asset, along with its projection of return on both its existing investment in the asset and the proposed additional investment, taking into account principally risks relating specifically to the asset (including the attitude of current or potential future tenants), and also to alternative uses of its resources and market conditions generally.

  Decisions on such crucial questions are explicitly entrusted by investors to the key executives of the AIFM ï who may well also be its owners ï on the basis of their experience, expertise, due diligence, intimate knowledge of the relevant asset and of the property market, and judgment. Whilst sophisticated institutional investors do have an interest in the rigour of the AIFM's analysis and in its decision-making framework (which typically involve safeguards of the sort described above) there is no investor-protection rationale for employing a less expert professional risk manager. Nor is there any group of sufficiently expert professionals from which such independent risk managers could realistically be recruited. In many structures, they could never be ultimately independent of the owners of the business, who are also the members of the investment committee. Putting it bluntly, if we are right that an individual needs essentially the same skills to risk-manage a real estate AIF as he or she needs in order to be one of its key investment managers, why would that individual ever choose to be its risk manager?

***Additional own funds and professional indemnity insurance requirements (PII)***

- **PII should deal with professional indemnity risk not wider operational risks**. We strongly oppose the proposed qualitative requirements based on the Advanced Measurement Approach, which appear to be mandatory. AMA is used by the largest banks and investment banks for calculating operational risk. The proposals in Box 7 should be deleted entirely. The proposal goes beyond the Level 1 text in addressing all manner of operational risks, whereas Article 9(7) is concerned exclusively with professional negligence risks, which is a much narrower category of risk.

- **The scope of PII cover needs to be revisited because, on the current proposals, it will be impossible to place such cover with insurers**. We broadly support the description of risks to be covered by PII in Box 6, except that we do not consider it appropriate for PII to cover the improper valuation of assets to the extent this is performed by an external valuer (which insurance would not be obtainable in the market). Nor do we consider it appropriate for PII to cover losses arising from business disruption or system failures or from failed processes. Whilst these risks may be insurable, they are not the subject of professional indemnity insurance as contemplated by the Level 1 text.

  The proposed conditions for qualifying professional indemnity insurance in Box 9 must be revisited because, as proposed, it would be impossible to find an insurer willing to write a policy meeting the conditions. In particular, the proposal that there should be no exclusions regarding liability risks (Box 9, § 1(c)) does not reflect the typical range of exclusions in any contract of insurance. In addition, the coverage of the insurance should relate only to the actions or omissions of the AIFM and should not extend to the actions or omissions of its "relevant persons" because it is proposed that that term should be defined to include not only the staff of the AIFM but also any "natural or legal person who is directly involved in the provision of services to the AIFM under a delegation arrangementé ". In a real estate context, relevant persons could therefore include the staff of the building manager (which coordinates maintenance, collects rents, arranges insurances and otherwise manages the land and buildings), developers or other service providers. Each of these parties will typically have its own professional indemnity insurance.

- **In relation to the method of calculation of additional own funds, we strongly prefer Option 1.**

**Property companies**

We find it very difficult to apply much of the draft technical advice to property companies. It seems clear to us that, like the Directive itself, the draft technical advice was not drafted with the intention that it should apply to such businesses. We summarise our concerns below.

We have in mind our members such as SEGRO plc, Hammerson PLC and Grosvenor Group Limited. Such companies are generally the holding companies of large groups which carry on several business lines relating to real estate. Whilst a very significant part of their business is likely to involve investment through wholly owned subsidiaries or joint ventures into land and buildings to derive rental income, they may also run diverse services businesses, such as property development or building management (maintenance, collection of rents, arranging insurance). Some are listed on the Official List of the London Stock Exchange but many more are not.

If they are to be treated as AIF, such property companies will fall to be treated as internally-managed AIF. We suggest that further consideration should be given to the way in which ESMA's proposed technical advice will relate to internally-managed AIF generally.

However, we believe that the only rational way to deal with our concerns as they would apply to property companies is for ESMA and the European Commission to acknowledge that the Directive does not apply to them **because they are not AIF**, and to clarify the uncertainty which presently exists on this point. Critically, we believe that such companies do not fall within the definition of an AIF because they do not raise capital "with a view to investing it in accordance with a *defined investment policyé for the benefit of investors*" (Article 4(1)(a)(i)).

Whereas a real estate fund will always have a "defined investment policy" (set out commonly in a private placement memorandum or a prospectus under Annex XV of the UK Prospectus Rules and agreed with investors), shareholders in a property company generally have no agreement with the company's management about any particular investment policy. Rather, the company's board of directors (like that of any other company) is free to determine its business strategy or strategies from time to time.

Since 2007, as a result of changes to UK tax legislation, many UK listed property companies have elected to be categorised for UK tax purposes as REITs ("Real Estate Investment Trusts"). We suspect that it is principally because of the use of the label "Investment Trust" that the uncertainty persists about the application of the Directive to property companies generally (whether or not REITs). UK REITs are so called principally because the term ñREITò is a strong global brand for listed property companies, most strongly in the United States and Australia but also, more recently, in many European jurisdictions, notably France. While the REIT label is very widely used internationally, the rules attaching to REIT status vary considerably from country to country. For example, we understand that in Australia "REITs" are commonly constituted as trusts, whereas in the UK they are simply companies. On the other hand, in the UK, it is not uncommon for analysts and investors to use the REIT label to refer to listed property companies generally, without always distinguishing between those that have elected into REIT status and those that have not.

In broad terms, a UK REIT must comply with certain tax law constraints on its business strategy and distribution policy in order to maintain the tax benefits associated with being a REIT. If it fails to do so, or if it decides that those constraints are incompatible with the way it wishes to develop its business strategy, it can lose REIT status as a matter of UK tax law. The fundamental nature of the company and the relationship between the companyôs shareholders and its management are, however, the same as for other, non-real estate, companies, regardless of whether the property company has REIT status at any particular time. Accordingly, we do not believe that the UK REIT label should have any relevance at all to the scope of application of the Directive. For the avoidance of doubt, we do not argue that no REIT is an AIF, simply that most property companies, whether REITs or not, should not be treated as AIF. An externally-managed REIT admitted to trading which has prepared a prospectus under Annex XV of the UK Prospectus Rules, for example, may well be an AIF.

If ESMA does not agree with this point, or if the European Commission is unwilling to clarify it, it is critically important that the following Level 2 issues should be addressed by ESMA in its technical advice to the European Commission:

- ***Depositaries:*** if a property company is to be treated as an AIF, then does it follow that its investment in the shares of its subsidiary operating companies (on its unconsolidated balance sheet) are to be treated as non-custody assets to be subject to the oversight of the depositary? Such subsidiaries are likely to include development companies, building management companies, joint venture companies (which may be accounted for as subsidiaries under the

new IFRS standards on consolidation), group treasury companies and service companies employing staff. There may also be numerous dormant or inactive companies in the group.

- ***Professional indemnity insurance and additional own funds:*** There are two points here. First, in respect of a property company, what are the professional negligence risks to which PII could apply? The company does not generally owe duties to its shareholders. In the absence of such duties, it is difficult to understand what is the insurable interest to which PII could relate. Second, to the extent that a property company employs additional own funds in place of professional indemnity insurance, how is its relevant income to be calculated for the purposes of Box 8, Option 1? It does not have income comparable to the income of an AIFM from its externally-managed AIF.

- ***Organisational requirements:*** those property companies which are listed are already subject to extensive rules and best practice guidance in relation to corporate governance. For example, a property company listed on the Official List of the London Stock Exchange will be subject to the UK Listing Rules, the Prospectus Rules, the Combined Code on Corporate Governance, as well as quasi-regulatory supervision by its sponsor investment bank. Similarly, AIM-quoted property companies are subject to the Prospectus Rules, the AIM Rules for Companies, quasi-regulatory supervision by their nominated adviser and will be subject to the corporate governance regime specified in their listing documents, typically the Quoted Companies Alliance Corporate Governance Guidelines. It is otiose to apply additional organisational requirements on them under the AIFMD implementing measures, but if any were to be applied it would be important to ensure that they were reasonably compatible with existing rules.

- ***Conflicts of interest:*** conflicts of interest arise where a person owes conflicting duties. A property company does not generally owe duties to its shareholders (although in English law they may be able to bring certain very limited claims against the company, for example for unfair prejudice to minority shareholders or derivative actions). In the absence of a duty of care to the shareholders (qua investors), it is difficult to make sense of the conflicts of interest implementing measures.

- ***Inducements:*** a property company's income does not derive from its shareholders, in the way that the income of an external AIFM derives from the AIF it manages (and thus indirectly from the investors in the AIF). Accordingly, it is very difficult to apply the proposed technical advice on inducements. Is all income of the property company to be treated as arising "in relation to the activities of collective portfolio management" and so subject to the requirement for disclosure?

- ***Leverage:*** most property companies engage in borrowing. Where borrowing is used to finance the acquisition of indirect real estate assets, the borrowing is usually undertaken by a company in which the principal company has invested. This is not, in most cases, to be regarded as leverage of the property company on the basis that it does not increase the exposure of the property company (Article 4(1)(v)), and on the basis that leverage at the level of a portfolio company (including a real estate portfolio company as well as a private equity or venture capital portfolio company) is not leverage unless it is guaranteed by the AIF (Recital 78). However, some property companies also borrow from banks or in the capital markets, in the same way as other corporate groups (manufacturers, retailers, etc.). Accordingly, if treated as internally-managed AIFs, they will be subject to the more onerous provisions applicable to AIFs which employ leverage, and which have been designed with hedge funds in mind ï even though they use leverage in essentially the same way as retail or manufacturing groups. That would be a strange, disproportionate and inappropriate outcome.

- ***Transparency Requirements:*** those property companies which are listed are already subject to the provisions of the Prospectus Directive and the Transparency Directive which govern their reporting to investors. Additional requirements are imposed by the UK Listing Rules or AIM Rules for Companies, where relevant. We welcome the fact that ESMA's proposals under Level 2 are broadly consistent with requirements deriving from other Directives but it seems implausible that property companies should be singled out and subjected to dual regulation.

Even if ESMA agrees with us, and the European Commission is willing to clarify the status of property companies, ESMA will need to grapple with the concerns we have raised so far as they relate to internally-managed AIF of other kinds. In our detailed responses in the Schedule, we have suggested how this might be achieved.

Yours faithfully

**Peter Cosmetatos**
**Director of Policy (Finance)**
**British Property Federation**
**pcosmetatos@bpf.org.uk**

**SCHEDULE**
**RESPONSES TO ESMA's QUESTIONS**

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| 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** |
| 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?<br><br>*BPF response*: We do not anticipate any material problems for real estate funds. However, for those in start-up situations, we assume that it would be appropriate for the AIFM to value investments at cost during the first twelve 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?<br><br>*BPF response:* No. This proposal is unwelcome for two reasons. First, the date chosen may not align with the accounting reference period for the AIF or the AIFM, which would impede it using data less than 12 months old. Second, it may put pressure on external resources, such as the services of external accountants, who may be called upon to assist with the calculations for several funds. We believe that the benefit of consistency between AIFM is outweighed by these disadvantages. |
| 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.<br><br>*BPF response:* Yes. We welcome the proposal to use NAV. We also welcome the recognition that the approach to calculating NAV will vary between types of AIF. In relation to real estate funds, GAAP will often be used. |
| Q5: Do you agree that AIFs which are exempt under Article 61 of the Directive should be included when calculating the threshold?<br><br>*BPF response:* No. <u>We strongly oppose this suggestion and we do not consider there to be any basis in the Level 1 text to support it.</u> |
| **III.II Influences of leverage on the assets under management** |
| 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 AIFôs net asset value?<br><br>*BPF response*: No. We share the concerns of other commentators (including those expressed at the Open Hearing) that the gross exposure method set out in Box 95 is:<br>• not, in fact, a measure of "leverage" properly understood, since that term is defined in the Directive as a means of increasing the exposure of the AIF, which implies netting; the Level 1 text obliges AIFM to take account of "assets acquired through leverage" but not gross exposure;<br>• overly complicated, particularly for the purposes of calculating the AUM of closed-ended funds investing in illiquid assets, such as real estate; and<br>• likely to produce misleading results. |

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| 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? |

*BPF response:* Yes. We agree that such positions should be excluded for the purposes of calculating the total value of assets under management.

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| 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? |

*BPF response:* We are content with Box 1. For the reasons set out in our answer to Q6 above, we find Box 2 difficult to follow and consider it to be overly complicated. We fear that AIFM (particularly smaller AIFM) will make mistakes when seeking to apply it, so that results will be inaccurate.

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

*BPF comments:* ESMA did not pose any questions in relation to Box 3 (information to be provided as part of registration). It is unlikely that, in the case of a real estate fund investing in illiquid assets for the long-term, there will be frequent changes to the information provided to competent authorities. We therefore propose the following amendment.

"4. The updated information referred to in this Article should be provided reasonably promptly whenever there is a material change ~~at least on an on a quarterly basis~~."

**IV General operating conditions**

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

*BPF comment 1:* We broadly support the description of risks to be covered by professional indemnity insurance in Box 6, except that we do not consider it appropriate for PII to cover the improper valuation of assets to the extent this is performed by an external valuer (which insurance would not be obtainable in the market) ï see Q9 below. Nor do we consider it appropriate for PII to cover losses arising from business disruption or system failures or from failed processes. Whilst these risks may be insurable, they are not the subject of professional indemnity insurance as contemplated by the Level 1 text.

Accordingly, we propose the following amendments to Box 6:

"(b)é

iv. improper valuation of assets and calculation of unit/share prices, in each case to the extent carried out by the AIFM internally

~~(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.~~"

*BPF comment 2:* The proposed conditions for qualifying professional indemnity insurance in Box 9 must be revisited because, as proposed, it would be impossible to find an insurer willing to write a policy meeting the conditions. In particular, the proposal that there should be no exclusions regarding liability risks (Box 9, § 1(c)) does not reflect the typical range of exclusions in any contract of insurance (for example for institutionalised fraud or deceit on the part of the AIFM not amenable to insurance or for claims covered under a previous policy). In addition, the coverage of the insurance should relate only to the actions or omissions of the AIFM and should not extend to the actions or omissions of its "relevant persons" because it is proposed that that term should be defined to include not only the staff of the AIFM but also any "natural or legal person who is directly involved in the provision of services to the AIFM under a delegation arrangementé ". In a real estate context, relevant persons could therefore

include the staff of the building manager (which coordinates maintenance, collects rents, arranges buildings insurances and otherwise manages the land and buildings), developers or other service providers. Each of these parties will typically have its own professional indemnity insurance.

Accordingly, we propose the following amendments to Box 9:

"(b) The cover provided by the policy is wide enough to include the liabilities of the AIFM and ~~relevant persons~~ its directors, officers and employees, including where relevant its or their professional negligence liabilities arising from the selection, appointment and monitoring of delegates;

(c) ~~There are no exclusions regarding~~ None of the liability risks listed in Box 1 are excluded in their entirety (though they may be subject to standard exclusions applicable to the policy generally);"

*BPF comment 3:* There is a need for tailoring for internally-managed AIF because it is not clear to whom the AIF owes a duty which is to be covered by professional indemnity insurance.

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?

*BPF response:* No, we do not. Please refer to our general comments above and suggested drafting amendments.

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

Q11: Please note that the term ôrelevant incomeô 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 (ôgross incomeô)?

*BPF response:* We do not share ESMA's assumption that the level of fee income is a good proxy for the riskiness of an AIFM's activities. We strongly prefer Option 2 in Box 8 and suggest that Option 1 should be deleted. We also believe that Option 2 would be likely to result in lower requirements for our members. For many firms, the requirement will nevertheless be substantial. We therefore also support the proposal, discussed at the Open Hearing, that there should be a cap on the amount of additional own funds required, and we suggest an appropriate cap would be EUR 1m.

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

*BPF response:* No. It is not clear to us whether the Advanced Measurement Approach (used only by the largest and most sophisticated banks and investment banks for calculating operational risk) is intended to be mandatory for all AIFM or an optional alternative. If mandatory, we strongly oppose it. If optional, we do not consider it to be of any practical use. Therefore, in either case, we suggest that the proposals in Box 7 should be deleted entirely. The proposal goes beyond the Level 1 text in addressing all manner of operational risks, whereas Article 9(7) is concerned exclusively with professional negligence risks, which is a much narrower category of risk.

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?

*BPF response:* Please refer to our answer to Q10 and Q11 above. We do not consider this approach to be appropriate.

Questions:

Q.15: 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 ú3.5 m, while for more than 100 investors, the amount in paragraph 3 (b)would be increased e.g. to ú4 m.

*BPF response:* We prefer the approach suggested in Box 9.

**IV. II. Possible Implementing Measures on General Principles**

**Duty to act in the best interests of the AIF or the investors of the AIF and the integrity of the market: Box 10**

*BPF comments:* Whilst the principles on fair treatment appear uncontroversial, their application in the context of real estate investment is difficult because there is no relevant formal market: transactions are privately negotiated bilateral deals. The explanatory text indicates that these principles are focused on AIF which regularly trade in financial instruments on formal markets.

ESMA's advice should make it clear that the AIFMs should take into account the nature, scale and complexity of the business of the AIFM and of the AIF they manage when constructing their policies and procedures.

Accordingly, we suggest the following change to Box 10:

"1. Where relevant, AIFM should apply appropriate policies and procedures for preventing malpractices that might reasonably be expected to affect the stability and integrity of the market."

**Due diligence requirements: Box 11**

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 ôbusiness planô Do you agree with the term ôbusiness planôor should another term be used?

*BPF response:* We support ESMA's approach, but suggest that references to a "business plan" are somewhat artificial. In the context of a real estate fund, what matters is the investment objectives, guidelines and restrictions agreed with investors.

Accordingly, we suggest the following amendment to Box 11:

"(a) ~~set out and update a business plan consistent with the duration of the AIF and market conditions~~ have regard to the investment objectives, guidelines and restrictions agreed with the AIF or investors;

(b) seek and select possible transactions consistent with the ~~plan~~ objectives, guidelines and restrictions referred to under point (a);

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(e) monitor the management performance of the AIF with respect to the ~~plan~~ objectives, guidelines and restrictions referred to under point (a)."

**Reporting obligations in respect of execution of subscription and redemption orders - Box 12**

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| *BPF comments:* It should be stated expressly that Box 12 is relevant only to open-ended funds.<br><br>Real estate funds are closed-ended and do not provide ongoing subscription or redemption opportunities to investors. Some real estate funds are structured as companies and others as limited partnerships. In a corporate context, subscription occurs on the initial offer of shares and once this has been concluded, investors' shares can be transferred in the secondary market without reference to the AIFM. In the limited partnership context, subscription is possible only by entering into a deed of adherence or other document subscribing to the limited partnership. There is no relevant "unit" issued to the investor, and no relevant "order" for subscription.<br><br>If Box 12 is not so limited in its application, it should be recognised that, in the case of a private closed-ended fund, (i) the provision does not apply at all to subsequent transfers of an investor's interest to a third party and (ii) on the initial investment, the application for shares or the relevant deed of adherence or other subscription document satisfies the obligation to provide the essential information concerning the execution of the order. |
| **Selection and appointments of counterparties and prime brokers – Box 13** |
| *BPF comments:* It is not clear on which provision of the Level 1 text ESMA bases this proposed advice. In any case, Box 13 has been drafted only with hedge funds in mind. Real estate funds do not use the services of prime brokers and will use the services of other brokers, intermediaries or counterparties only very rarely.<br><br>Typically, private equity real estate AIF and property companies subscribe for securities in the companies in which they invest, which companies either acquire or already hold title to the underlying land and buildings. Such transactions are privately negotiated and do not generally involve any broker or other intermediary, except that the AIFM may be introduced to the transaction by a third party.<br><br>Real estate AIFM may use the services of a broker or counterparty occasionally, when entering into derivative transactions for the purposes of hedging.<br><br>We suggest that Box 13 should cover a situation only where an AIFM transacts with a broker or counterparty providing an investment service or carrying on an investment activity on a professional basis within the meaning of MiFID. |
| **Execution of decisions to deal on behalf of the managed AIF – Box 14** |
| *BPF comments:* It is clear from ESMA's comments in paragraph 21 on page 48 that § 2 to 5 of Box 14 are not intended to apply to real estate AIF but this is not reflected adequately in the Box itself.<br><br>We suggest the following amendment to Box 14:<br><br>"5. Whenever there is no relevant execution venue (as when dealing in shares or other instruments which are not traded on formal markets) or 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." |
| **Placing orders to deal on behalf of AIFs with other entitles or execution – Box 15** |
| *BPF comments:* It is clear from ESMA's comments in paragraph 24 on page 49 that that § 2 to 4 of Box 15 are not intended to apply to real estate AIF but this is not reflected adequately in the Box itself. Please refer to our comment on Box 13 above: real estate AIF do not typically place orders with third parties for execution. |

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| **Handling of orders – general principle – Box 16** |
| *BPF comments:* It is clear from ESMA's comments in paragraph 25 on page 49 that Box 16 is not intended to apply to real estate AIF but this is not reflected adequately in the Box itself.<br><br>We suggest the following addition to Box 16:<br><br>"This Box shall not apply where there is no relevant order (i.e. an order to buy or sell a financial instrument such as a security or derivative traded on a formal market) as in the case of investment in real estate, partnerships or unlisted companies." |
| **Aggregation and allocation of trading order – Box 17** |
| *BPF comments:* It is clear from ESMA's comments in paragraph 27 on page 50 that Box 17 is not intended to apply to real estate AIF but this is not reflected adequately in the Box itself.<br><br>We suggest the following addition to Box 17:<br><br>"This Box shall not apply where there is no relevant order (i.e. an order to buy or sell a financial instrument such as a security or derivative traded on a formal market) as in the case of investment in real estate, partnerships or unlisted companies." |
| **Inducements – Box 18** |
| *BPF comments:*<br><br>If the inducements rule is to be imposed upon AIFM, then it requires tailoring to internally-managed AIF. In relation to internally-managed AIF, it is not clear what are the fees, commissions or non-monetary benefits "in relation to the activities of collective portfolio management of AIFs", since on one interpretation that term would appear to be capable of catching the whole of the AIF's income but, on an alternative interpretation, none of it. The investors own the AIF which is paying and receiving fees, commissions or the non-monetary benefit. Accordingly, the investor indirectly owns the benefit of any fee received. There is therefore no possibility of conflict with the interests of investors when an internally managed AIF receives a fee, commission or non-monetary benefit. These arrangements should always be permitted. We therefore propose that Box 19 should not apply to internally-managed AIF at all.<br><br>In any case, we believe that imposing the inducements rule on AIFM goes beyond what is required properly to implement Level 1. In the context of MiFID and UCITS, the inducements rule is principally a retail investor protection measure. In the wholesale context, any relevant concerns should be dealt with adequately under Article 14 concerning conflicts of interest generally. We are not aware of any identified market failure in relation to real estate funds which justifies the additional cost of compliance with the rule. |
| **Fair treatment by an AIFM – Box 19** |

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| Q17: Do you agree with Option 1 or Option 2 in Box 19? Please provide reasons for your view.<br><br>*BPF response:*<br><br>No - we oppose both Options.<br><br>Article 12 (1) of the Directive states that "No investor in an AIF shall obtain preferential treatment, unless such preferential treatment is disclosed in the relevant AIF's rules or instruments of incorporation." This clearly contemplates that an investor can be given preferential treatment provided that this is disclosed in the AIF's rules or instruments of incorporation regardless of whether or not that preferential treatment gives rise to a material disadvantage to other investors.<br><br>ESMA's proposed advice therefore goes beyond the scope of Level 1.<br><br>It is also unclear what is meant by "an overall material disadvantage to other investors".<br><br>We suggest that ESMA's advice should make it clear that where preferential treatment may or does occur, investors are treated fairly if this is disclosed to them. The disclosure referred to in Article 12(1) can be made in general terms in the AIF's prospectus or offering document provided that the details of any such preferential treatment are disclosed to those investors affected thereby prior to investment.<br><br>In the context of real estate AIF, it is common practice for side letters to be issued and/or most favoured nation provisions to be used in relation to different groups of investors and these arrangements are disclosed to the investors affected thereby prior to investment. |
| **IV.III Possible Implementing Measures on Conflicts of Interest** |
| **Types of Conflict of Interest – Box 20**<br>**Conflicts of interest policy – Box 21**<br>**Independence in conflicts management – Box 22** |
| *BPF comments:* We broadly support ESMA's approach in the context of externally managed AIF, which is based on MiFID and UCITS requirements.<br><br>However, we believe there is a need for a different approach for internally-managed AIF where the AIF and the AIFM are the same entity. An internally managed AIF can only engage in activities for itself ï it does not have other clients, it does not receive fees for managing itself, it does not make gains or avoid losses at the expense of itself. The types of conflicts identified in Box 20 (and indeed in Article 14(1)) don't apply to an internally managed AIF.<br><br>Internally managed AIF should have regard to their duties and obligations to their investors in accordance with the established legal principles applicable to the legal structure of the AIF concerned and to consider and identify any potential conflicts of interest in that context. |
| **Record keeping of activities giving rise to detrimental conflicts of interest and way of disclosure of conflicts of interest – Box 23** |
| *BPF comments:* We broadly support ESMA's approach, but note that the disclosure obligation is broader than the Directive would appear to require. The requirement to disclose conflicts of interest between delegates or sub delegates and the AIFM or the investors in the AIF should not be broader that the disclosure requirements of Article 14 (1) and (2) of the Directive. ESMAs advice should be clarified so that only those disclosures relevant under Article 14 (1) and (2) and which relate to a delegate should be disclosed. |
| **Strategies for the exercise of voting rights – Box 24** |
| *BPF comments:* These proposals have been developed in contemplation of the AIFM being called upon to vote on corporate actions in the context of listed portfolio companies. The proposals are disproportionate in the context of AIF which typically invest in unlisted companies or units in unit trusts, which in turn invest in land and buildings. Whilst there are likely to be voting rights attaching to these assets, the AIF will typically own all of the voting rights and may be called upon to vote only very infrequently. Accordingly, we propose the |

following amendments to Box 24:

"1. Where relevant, 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. Where relevant, 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. Where relevant, 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."

**IV.IV. Possible Implementing Measures on Risk Management**

*BPF comments:*

We welcome ESMA's recognition in paragraph 3 on page 63 that many respondents to the call for evidence observed that it would present significant challenges for private equity firms to separate risk and portfolio management activities. This point is equally true in relation to real estate fund managers for essentially the same reasons. We also welcome the recognition (in Box 30) that it may not be possible for many AIFM to comply with the full-blown requirements for a functionally and hierarchically separate risk management function.

We would go further. Real estate investment is fundamentally different from trading in financial instruments on formal markets. A potential investment opportunity will often take several months to evaluate and execute a transaction to complete the investment. Decisions are taken by the investment committee rather than individual portfolio managers and investment opportunities will often be assessed and reassessed by the investment committee several times at different stages in the transaction process.

For AIFM whose strategy is to invest in illiquid assets for the long-term, risk management is bound up in the investment decision-making process. The risk assessment is not susceptible to separation in the way that, for example, the trading decisions of a hedge fund portfolio manager are subject to quantitative risk limits (of the sort contemplated in Box 29) imposed and monitored by a specialist professional. For example, when a real estate fund management firm considers whether to make a further investment into an existing asset to fund repairs, improvements or sustainability enhancements to the fabric of a building, the starting point for its decision is its expert assessment of the current value of its current asset, along with its projection of return on both its existing investment in the asset and the proposed additional investment, taking into account principally risks relating specifically to the asset (including the attitude of current or potential future tenants) and also to alternative uses of its resources and to market conditions generally.

Decisions on crucial questions of risk management are entrusted by investors to the key executives of the AIFM ï who may well also be its owners ï on the basis of their expertise, judgment, due diligence, intimate knowledge of the relevant asset and the property market. It should not be forgotten that the incentive structures for the AIFM (for example, performance fees, co-invest or carried interest) are typically based on the proceeds arising on the realisation of an investment. Whilst sophisticated institutional investors do have an interest in the rigour of the AIFM's analysis and in its decision-making framework (which typically involve safeguards such as decisions being taken by committee after rigorous challenge and debate) there is no investor-protection rationale for employing a less expert professional risk manager. The investment approach of the manager is subject to detailed scrutiny by the prospective investors before deciding whether or not to participate in the fund. To impose a separate risk management exercise by reference to a matrix developed purely for regulatory purposes and designed primarily for hedge funds is a retrograde step and runs the risk of a tick-the-box approach developing. In the context of real estate investment, there is no pool or group of

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| sufficiently expert professionals from which such independent risk managers could be recruited. In many structures, they could never be ultimately independent of the owners of the business, who are also the members of the investment committee and of the governing body.<br><br>For all of those reasons, ESMA is correct to develop an alternative approach based on safeguards set out in Box 30, § 3 (please refer to our proposals below). However, the current suggestions for safeguards are unworkable because they contemplate a separate group of people performing the risk management function. In particular, the proposal that risk managers should be compensated independently of the performance of the business is impossible to achieve in most current structures (large or small) and is disproportionate to any investor-protection concern. We suggest that the topic of remuneration is already addressed adequately in the Level 1 provisions on remuneration, and that there will be an opportunity to address this topic fully through ESMA's guidance on remuneration.<br><br>In paragraph 35 on page 75, ESMA recognises that the competent authorities charged with reviewing the functional and hierarchical separation of the risk management function can take into account various criteria including the governance structures of the AIFM, the marginal benefits versus costs to investors of implementing safeguards, the extent to which the risk management function is inseparable from the portfolio management function and the expectations of professional investors. We suggest that these criteria are added to the formal advice in Box 30. |
| **Permanent Risk Management Function – Box 25** |
| *BPF comments:* We broadly support ESMA's approach, on the understanding that the requirements will be applied proportionately to the nature, scale and complexity of the AIFM's business and that the permanent risk management function may comprise senior investment professionals, and therefore subject to our comments below about the functional and hierarchical separation of the risk management and portfolio management functions. |
| **Risk Management Policy – Box 26** |
| *BPF comments:* We support ESMA's approach, in particular the express reference to the application of the rules taking into account the nature, scale and complexity of the AIFM's business and of the AIF it manages. |
| **Assessment, monitoring and review of the risk management policy – Box 27** |
| *BPF comments:* We are not sure that the proposals satisfy a cost-benefit analysis because we fear that they will generate excessive amounts of data for competent authorities in sectors which do not pose significant investor protection risk and no systemic risk. However, we could live with them. |
| **Measurement and Management of Risk – Box 28** |
| *BPF comments*: We broadly support ESMA's approach. However, ESMA should make § 3 subject also to the qualification concerning proportionality in § 2. In the context of real estate funds the risk management procedures and processes will be substantively different from those applicable to funds trading in liquid financial instruments on formal markets. The proportionality principle is therefore of fundamental importance and should be applied to all risk management requirements. |
| **Risk Limits – Box 29** |
| *BPF comments*: Box 29 has been developed by reference to risk categories relevant to banks and investment banks. Funds, such as real estate funds, investing in illiquid assets for the long term are likely to face different risks. Whilst real estate AIFM could develop self-serving documents addressing the identified risks we suggest that it would be more meaningful to leave it to each AIFM to develop its own risk assessment framework. For example, for a real estate AIFM, these would be likely to focus on broader macro-economic risks.<br><br>Accordingly, we suggest the following changes to Box 29:<br><br>"2. The qualitative and quantitative risk limits for each AIF shall, <u>where relevant,</u> ~~at~~ |

~~least,~~ cover the following risks:

(a) market risks;

(b) credit risks;

(c) liquidity risks;

(d) counterparty risks; and

(e) operational risks."

**Functional and Hierarchical Separation of the Risk Management Function – Box 30**

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?

Q19: ESMA would like to know which types of AIFM will have most difficultly 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 hierarchal independence in accordance with the proposed advice and in consideration of the safeguards listed?

*BPF response:* Please refer to our general comments above. In light of them, we suggest the following changes to Box 30 which emphasise the importance of effective risk management in the context of the nature of the AIFM's business and the AIF it manages:

We have made substantial changes and not all deletions are shown.

"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 and considering the safeguards employed by the AIFM. The criteria that competent authorities may use when making this assessment include:

(a) the operational structure of the AIFM/AIF and the impact on effective risk management resulting from the risk management function not being functionally and hierarchically separated;

(b) the corporate governance arrangements at the AIFM / AIF;

(c) the marginal benefits versus the costs to investors of implementing the safeguards;

(d) the extent to which the risk management function is inseparable from the portfolio management function;

(e) the levels of competent staff in the organisation; and

(f) the expectations of professional investors as to the benefits of changes to the risk management function."

"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 effective performance of the risk management function. These safeguards shall be documented in the risk management policy and must include (a), (d) and (e) and

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| | may also include (b) and (c) to the extent relevant and proportionate taking into account the nature, scale and complexity of the AIFM:<br><br>(a) procedures to ensure that the data used by the risk management function in making decisions is reliable;<br><br>(b) formal written investment and divestment proposals drawn up by explicit reference to applicable investment guidelines, and addressing risks relevant to each asset and the risk-profile of the portfolio as a whole;<br><br>(c) decisions to be taken by committee, facilitating the internal challenge of ideas, with key points minuted;<br><br>(d) compliance with Article 13 in relation to remuneration; and<br><br>(e) compliance with Article 14 in relation to conflicts of interest." |
| **IV.V. Possible Implementing Measures on Liquidity Management** | |
| 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? |
| *BPF response:* Whilst we can see that for certain types of AIF these would be regarded as normal liquidity management tools they are not relevant for closed ended real estate funds. | |
| **IV.VII. Possible Implementing Measures on Organisational Requirements** | |
| **General requirements on procedures and organisation – Box 44** | |
| *BPF comments:* We broadly support ESMA's approach. We believe that the proportionality principle acknowledged in No 1 of Box 44 should be applied to all of the general requirements on procedures and organisational requirements set out in Box 44. | |
| **Resources – Box 45** | |
| *BPF comments:* We broadly support ESMA's approach. In relation to the requirement to make "appropriate arrangements" the advice should make express reference to the nature, scale and complexity of the AIFM's business and the nature and range of services and activities undertaken by the AIFM. | |
| **Electronic data processing – Box 46** | |
| *BPF comments:* We broadly support ESMA's approach. In relation to the requirement to make "appropriate arrangements" the advice should make express reference to the nature, scale and complexity of the AIFM's business and the nature and range of services and activities undertaken by the AIFM. | |
| **Control by senior management and supervisory function – Box 48** | |
| *BPF comments:* We broadly support ESMA's approach. We believe No 2 (b) should refer to the fund rules, instrument of incorporation, prospectus and offering documents as it is in those documents that the investment strategy is usually defined. § 2 (b) should be amended to read as follows:<br><br>"(b) approves or oversees the approval of the investment strategies for each managed AIF in accordance with the fund rules, the instruments of incorporation, the prospectus or offering documents;" | |

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| **Personal transactions – Box 51** |
| *BPF comments:* We broadly support ESMA's approach. However Article 18 of the Directive only requires rules for personal transactions by the AIFM's employees. ESMA's advice goes beyond this as it would require third party delegates of the AIFM to comply with these requirements. It may be difficult in practice for the AIFM to ensure compliance with these requirements. Except in relation to the delegation of investment management activities (where the delegate is likely to be under the same substantive obligation in any event as it will be regulated) it is unclear what purpose is served by this requirement. |
| **Recording of subscription and redemption orders – Box 53** |
| *BPF comments:* ESMA's approach on recording of subscription and redemption orders is appropriate in the context of open-ended AIF where subscriptions and redemptions occur on a regular basis and impact the level of assets under management of the AIF. It is less clear how this provision should or could be applied in the context of closed-ended funds or listed companies where transactions in interests of the AIF can occur otherwise than through the AIFM either by private transaction or, for listed entities, through secondary market trading. The explanatory text to Box 53 suggest that ESMA believes these recording keeping requirements are appropriately adapted for all types of AIF. It should be made clear that these requirements only apply where the transaction in the interests of the AIF is effected with or through the AIFM. |
| **IV.VIII. Possible Implementing Measures on Valuation** |
| **Policies and procedures for the valuation of the assets of the AIF – Box 55** |
| *BPF comments:* We support ESMA's draft advice generally, subject to one point of detail and one substantive concern.<br><br>The point of detail concerns the second sentence of § 2 of Box 55. "The valuation methodology in respect of the specific type of asset has to be identified prior to investment in that type of asset".<br><br>We are concerned that "type of asset" could be taken to refer to a particular legal type of asset, such as a share, unit or bond and that the implication is that every share must be subject to the same valuation methodology as every other share, or every unit to the same methodology as every other unit. This cannot be intended. AIFM (or their external valuers) should be permitted to employ different valuation methodologies depending on all the circumstances pertaining to the particular asset. We suggest the following change to that sentence:<br><br>"An AIFM shall not invest in a particular type of asset for the first time unless appropriate valuation methodologies have been identified".<br><br>The substantive concern relates to the functional independence of the valuation function. We note that the European Commission is not required by the Directive specifically to develop technical standards relating to the functional independence of the internal valuation function (Article 18(4)(b)). However, we believe that it would be appropriate for ESMA to comment on it in the context of its technical advice on the procedures for the proper valuation of the assets and the calculation of NAV, including because this topic presents issues very similar to those concerning the functional and hierarchical separation of the risk management function. We refer to our general comments above concerning ESMA's possible implementing measures concerning the risk management function, and to our suggested amendments to Box 30. We believe ESMA should focus on the effectiveness of the internal valuation function<br><br>In the UK real estate industry, there are already well developed standards for the independent valuation of land and buildings. These are developed and maintained by the Royal Institution of Chartered Surveyors (RICS). You can find out more about RICS at: http://www.rics.org/ . RICS administers professional qualifications for property surveyors and publishes standards for valuation practice. Almost all commercial real estate assets in the UK in which funds invest will be subject to a RICS valuation (although not necessarily on a regular basis). However, |

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| that valuation will relate only to the land and buildings. The valuation will not relate to the value of the shares or units in which the real estate AIF has invested, or to the value of the units in the AIF. We understand that a RICS valuation would therefore not constitute an external valuation for the purposes of the Directive.<br><br>We suggest that, where relevant, the fact that the AIFM uses an independent, third party professional to provide a valuation of the underlying land and buildings and that valuation forms a key part of the valuation of the AIF's assets (even though the land and buildings are not themselves the relevant assets), this may be an important consideration when determining that the internal valuation function is effective and sufficiently "functionally independent". |
| **Review of individual values – Box 59** |
| *BPF comments:* We are not sure what this Box is intended to add to the others and suggest that it could be deleted. |
| **Calculation of net asset value per unit or share – Box 60** |
| *BPF comments:* It is far from clear how the concept of a "unit or share" should be applied in the context of AIF which issue neither shares nor units (of the sort contemplated in Level 1) such as real estate AIF structured as limited partnerships. In these cases, the investors' interest in the AIF is a bundle of property and contractual rights, labelled a "limited partnership interest".<br><br>For this reason, it is not meaningful to require the number of units or share in issue to be verified. Accordingly, Box 60 § 4 should be amended as follows:<br><br>"4. Where relevant, 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." |
| **Professional guarantees – Box 61** |
| *BPF comments:* We welcome ESMA's proposal. |
| **Frequency of valuation carried out by open-ended funds – Box 62** |
| *BPF comments:* It should be made explicit in the text of this Box that it relates only to open-ended funds, as its title suggests. |
| **IV.IX. Possible Implementing Measures on Delegation** |
| *BPF comments:* We fear that there is some ambiguity about the circumstances in which the provision of a service by a third party constitutes a delegation by the AIFM.<br><br>Article 20 refers to third parties carrying out tasks "oné behalf" of the AIFM. This imports the concept that the third party must be performing a service which the AIFM would otherwise itself be expected to perform pursuant to its contract with the fund or pursuant to the Directive.<br><br>It is instructive to refer also to Article 13(5) MiFID, where the equivalent provisions on outsourcing refer to a firm "relying on a third party for the performance of operational functions which are critical for the provision of continuous and satisfactory service to clients and the performance of investment activitiesé ".<br><br>Not every case in which an AIFM involves a third party will constitute a delegation by the AIFM. For example, if the AIFM instructs lawyers to provide it with legal advice concerning an investment, this is not a delegation because it is not a function which the AIFM would have been expected to internalise or which was part of its service. Similarly, if a commercial real estate asset manager procures specialist scientific advice on potentially contaminated land, this is not an instance of delegation within the meaning of the Directive.<br><br>We are concerned that the consultation paper does not always reflect this distinction. |

In addition, we believe there is a need for further tailoring to internally-managed AIFM because there is no external frame of reference for the obligations the AIFM has taken on, against which to assess whether a particular arrangement constitutes a delegation or not.

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

*BPF response:* We prefer Option 1 because of the danger that supervisors might come to regard Option 2 as an exhaustive list of the legitimate objective reasons for delegation.

**V. Depositaries**

*BPF general comments:*

It is clear in the Level 1 text that the function of the depositary in relation to such other assets is one of oversight. This question has been settled and ESMA should not reopen any debate about it. We therefore strongly favour ESMAôs proposals which properly reflect this (notably Option 1 in Box 81) and strongly reject both express suggestions in the consultation paper that the depositary might exercise ex ante control (e.g. p. 165, § 49) and proposals which come close to it in effect (e.g. Box 76, Option 1 ï the proposal for a central hub for cash accounts, and Box 81, Option 2 - the proposal for ñmirroringò of accounts). Failure to respect this distinction would be inconsistent with the Level 1 text and would result in the depositary having a level of control which could undermine the AIFM as the discretionary investment manager of the AIF. This would be totally contrary to the expectations of the AIF's sophisticated institutional investors who would have done extensive due diligence on and selected the AIFM, as opposed to the depositary. It was for all of these reasons that the political agreement at Level 1 was on an oversight function only. We disagree with ESMA's statement (on page 162, paragraph 43) that the provision of prior information to the depositary is feasible in the case of real estate AIF.

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?

*BPF response:* With respect to ESMA, we strongly oppose this suggestion. We suggest that ESMA should not (and that it is not empowered under Level 1) to provide this advice to the European Commission because it would entirely subvert the alternative depositary regime provided for in Article 21(3), final paragraph. That paragraph contemplates that the depositary may be an entity other than a credit institution. However, it would not be possible to open a cash account with a depositary which was not a credit institution.

Even if the depositary is a credit institution, not all types of AIF have a dedicated subscription and redemption account, particularly those which are closed-ended. So this requirement would in some cases be difficult to apply.

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

*BPF response:* No. For real estate funds, there are no problems with referring to Article 18 of the MiFID Implementing Directive.

**Cash Monitoring – general information requirements – Box 75**

*BPF comments:*

We assume that the cash flow monitoring requirements are intended to apply only in relation to the accounts of the AIF (and Box 75 correctly refers to accounts in the name of the AIF or of the AIFM acting for the AIF). It would not in our view be justified by the Level 1 text or, indeed, practicable for the depositary to seek to monitor the cash flows of the real estate operating and investment businesses of the companies, partnerships or other entities in which the fund

invests, any more than the depositary of a private equity fund would be expected to monitor the cash flows of such a fund's portfolio companies. Please refer to our general comments above in relation to Box 39 about look through generally.

In paragraph 4 on page 147 ESMA suggests that the depositary needs to have a ñclear overview of all cash inflows and outflows in all instances ... and é access to all information related to all cash flowsò. This is also indicated in Box 75 which requires ñaccess to all informationò.. and ... ñclear overview of all the AIFôs cash flowsò. As well as supporting ESMA's Option 2 in Box 76 (see our response immediately below and our general comments above) the type of information about accounts needed by the depositaries should be limited to that required to enable it to carry out ex post monitoring in the way envisaged by Option 2.

Accordingly, the third bullet point of Box 75 should be amended as follows:

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- the depositary is provided with all <u>such material</u> information related to the cash accounts opened at a third party entity, directly from those third parties ~~in order~~ <u>as is necessary for it properly to monitor cash flows in accordance with Box 76</u> ~~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.~~ "

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

*BPF response:* For the reasons set out in our general comments above, we prefer Option 2.

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

*BPF response:*

We support Option 2. We understand that Option 2, which refers to instruments held in settlement systems is a proxy for tests such as whether the instrument has all of the following features: liquidity, fungibility and transferability on a formal market. If ESMA does not adopt Option 2 as drafted, it is critical to real estate funds that these features are recognised as being necessary for an instrument to be treated as one which should be held in custody.

Private equity real estate AIF and property companies rarely invest directly into land and buildings (in the sense that the AIF or the AIFM is not itself the owner, named in the documents or register evidencing title to the land). Rather, they invest in companies or other vehicles (frequently units in unit trusts) which own the land and buildings. It is clear from ESMA's paragraph 26 that the intention is that such real estate assets should not be treated as ñfinancial instruments that should be held in custodyò, whether under Option 1 or Option 2.

However, in our view Option 1 is unclear, and it begs the question about the nature of the asset. It is not obvious whether real estate assets would fall to be treated as financial instruments that should be held in custody under Option 1 because they *could* be registered in an account in the name of the depositary or the depositary's nominee. We argue that there should be no <u>requirement</u> that they are so held.

When real estate AIF invest in private limited companies in some jurisdictions, they are commonly issued with a share certificate. In most jurisdictions, the share certificate is one aspect of evidence of title, but title cannot be transferred by delivery of the certificate or by endorsement. Such share certificates should not be treated as a financial instrument that should be held in custody. The depositary's role in relation to share certificates should be one of oversight. If a share certificate were treated as a financial instrument that should be held in custody then many real estate AIF, including all private equity real estate AIF, would not qualify for the conditions in Article 21(3) final subparagraph, and the Level 1 text would be undermined.

It should therefore be made clearer in Box 78 that physical assets need only be held in custody by the depositary to the extent that they are financial instruments *title to which can be transferred by physical delivery* (i.e. bearer instruments, which are referred to in the Level 1 text as being issued in "nominative form" (Article 21(17)(3)(c)(iii)).

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| 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? |

*BPF response:* At present, in the UK, FSA authorised investment managers hold in their own custody (or through their nominee) the shares in companies, or units in unit trusts belonging to the real estate fund, which companies or trusts invest in turn in land and buildings. They are also entitled to have a mandate over the cash accounts of the funds. There has been no recorded incident of misappropriation of assets under this model.

**Safekeeping duties related to 'other assets' – Ownership verification and record keeping – Box 81**

*BPF comments:* For the reasons set out in our general comments above, we strongly favour Option 1 in Box 81.

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

*BPF response:*

Private equity real estate AIF and property companies rarely invest directly into land and buildings (in the sense that the AIF or the AIFM is not itself the legal owner in the documents or register evidencing title to the land). Rather, they invest in companies or other vehicles (frequently units in unit trusts) which own the land and buildings. We believe it should be made clearer in ESMA's feedback to the consultation and in the draft technical standards that the circumstances and extent to which the depositary must ñlook throughò the assets of the AIF are very limited. The depositary will of course need to recognise the fact that the companies and other vehicles in which the AIF has invested themselves hold underlying assets (in our case the title to real property). For example, it must in practice do so in order to discharge its obligation to have oversight of the valuation process (Article 21(9)(b)). However, it is vital that it be understood that the depositary is not required to *verify the ownership* of the underlying assets. If this were required in the context of real estate funds, then the depositary would be required to obtain an independent legal opinion on the quality of title. Such opinions would be duplicative of the work done by the AIFM in due diligence, very costly (in the order of tens of thousands of pounds per item) and inevitably subject to caveats, thus rendering the ultimate benefit of such an exercise questionable. In addition, where more than one AIF was invested in a company, it would make no sense for each depositary to be required to verify the title of the company to land and buildings owned by it: this would be entirely duplicative and it would ignore the reality that the company owns the asset and that each AIF has economic exposure to only a fraction of the asset. A look-through approach would also be inconsistent with current custody practice, as well as the legal analysis applicable to depositaries of AIF or UCITS investing in the listed holding company of a large group (such as Vodafone Group PLC), where the depositary is responsible for the title to the share in the PLC and not for verifying title to shares in its operating subsidiaries (such as Vodafone Essar in India) or for verifying the ownership of physical assets (such as mobile telephone masts).

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| 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? |

*BPF response:* Corporate funds and some institutional real estate funds may be unitised, in which case there is internal reconciliation of subscription orders with subscription proceeds. Many "private equity real estate funds" are not unitised and they deal with reconciliations internally. In addition, in a closed-ended fund, subscription does not happen at the same time as funding. Funding is drawn down over time as investments are made. There is therefore no need for any reconciliation procedure.

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| 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? |

*BPF response:* The requirement does not extend beyond sales by the AIF or the AIFM. Under Level 1, the depositary has no role in relation to third party transfers.

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| Q44: With regards to the depositaryôs duties related to the carrying out of the AIFMôs 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.<br><br>*BPF response:* Yes. We believe that Box 85 allows sufficient flexibility for depositaries to perform their function in relation to funds of differing types. |
| Q45: Do you prefer option 1 or option 2 in Box 86? Please give reasons for your view.<br><br>*BPF response:* We do not have a strong preference for either Option 1 or Option 2. It is critical to understand that, in the context of real estate, there are no "usual time limits" for transactions in privately held companies. We think that Box 86 Option 2 only restates the Level 1 text and states what would be obvious to a depositary. |
| Q46: What alternative or additional measures to segregation could be put in place to ensure the assets are ôinsolvency-proofô 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 which countries would this be the case? Please specify the estimated percentage of assets in custody that could be concerned.<br><br>*BPF response:* Assets should be registered in the name of the fund (or its general partner in the case of a limited partnership) so as to avoid any questions about segregation. |
| **VI. Possible Implementing Measures on Methods for Calculating the Leverage of an AIF and the Methods for Calculating the Exposure of an AIF** |
| *BPF comments:*<br><br>These provisions are complex and have been designed with hedge funds in mind.<br><br>Real estate AIF do not typically use leverage in connection with investments. The companies in which the AIF invest may borrow, usually secured on the underlying land and buildings but without recourse to the AIF or its other assets. Please refer to our response to Q60 below.<br><br>However, some internally-managed real estate AIF may borrow. Where these are property companies, they may borrow bank debt or participate in the debt capital markets in exactly the same way that other companies borrow.<br><br>We suggest that ESMA should provide that an AIF that invests only in the equity of unlisted companies or similar vehicles and does not engage in any methods of increasing the exposure of AIF managed by it other than through cash borrowings may calculate its exposure as the amount of investor capital committed to investments, plus the amount of such borrowings. Consistent with Level 1, such AIFM should be entitled to ignore cash borrowings that are temporary in nature and are covered by investor capital commitments. |
| 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?<br><br>*BPF response:* No. We believe that Box 98 is sufficient for the purposes of ESMA's advice to the European Commission. |
| 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?<br><br>*BPF response:* We appreciate ESMA's effort to take account of the wide variety of AIFs. However, as noted in our general comments above, we believe that there is a need for a |

separate, much more simple benchmark for simpler fund models such as those used in the real estate industry.

We suggest that Box 93 should provide additionally as follows:

"In relation to an AIF that invests only in the equity of unlisted companies or similar vehicles and does not engage in any methods of increasing the exposure of AIF managed by it other than through cash borrowings (including on the debt capital markets), the AIFM may calculate the AIF's exposure as the amount of investor capital committed to investments, plus the amount of such borrowings."

Q57: Is further clarification needed in relation to the treatment of contingent liabilities or credit-based instruments?

*BPF response:* Yes. We find the draft advice difficult to follow. We suggest that reference is instead made to applicable accounting practices.

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?

*BPF response:* Subject to our general comments on the gross method, we agree on this point of detail.

Q59: Which of the three options in Box 99 do you prefer? Please provide reasons for your view.

*BPF response:* We prefer Option 3, although we think the language could be simplified as follows:

"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 to the extent that there is recourse to the AIF, or to other assets or investments of the AIF, for obligations of such target company or collective investment scheme."

Options 1 and 2 are completely unsatisfactory because of the uncertainty introduced by their references to non-binding expectations that further funding will be made available. There is no basis in Level 1 for adopting this approach.

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?

*BPF response:* No. We strongly disagree. The term "leverage" is clearly defined in Level 1 and recital 78 makes clear that the obligations of companies in which an AIF invests are not the obligations of the AIF. Recital 78 applies as well to "private equity real estate" structures as it does to other private equity or venture capital structures. ESMA is not empowered to unpick Level 1.

**VIII. Transparency Requirements**

**VIII.I. Possible Implementing Measures on Annual Reporting**

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?

*BPF response:* Yes. We support ESMA's approach.

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| 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? |

*BPF response:* We caution against over-reliance on the work of CEBS in relation to the remuneration provisions of the Capital Requirements Directive (page 227, paragraph 29). That guidance was developed in a very different set of circumstances for a different industry with markedly different remuneration practices. We welcome ESMA's recognition that there will need to be additional tailoring and we suggest that such tailoring may need to be substantial. The BPF looks forward to working with ESMA on this in due course.

**VIII.II. Possible Implementing Measures on Disclosure to Investors**

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| 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? |

*BPF response:* It should be made clear in Box 107 that disclosure of liquidity management arrangements is not required of AIFM of unleveraged closed-ended AIF, such as many real estate AIF (Article 16).

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| Q66: | Do you agree with ESMA's proposed definition of special arrangements? What would this not capture? |

*BPF response:* Real estate funds represented by the BPF do not generally employ gates or side pockets.

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| Q67: | Which option for periodic disclosure of risk profile under Box 107 do you support? Please provide reasons for your view. |

*BPF response*: We support Option 1. The risk profile of a real estate AIF does not alter during its life.

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.

*BPF response:* No. We do not see any need for greater specificity and we fear it would be problematic to provide it in relation to the heterogeneous population of AIF.

**VIII.III. Possible Implementing Measures on Reporting to Competent Authorities**

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| Q69: | Do you agree with the proposed frequency of disclosure? If not, please provide alternative suggestions. |

*BPF response:* No. We believe that the proposal requires too frequent reporting, the cost of which cannot be justified by any benefit in relation to real estate AIF which do not pose systemic risks. More frequent reporting will result in regulators being overwhelmed by meaningless data. We suggest that reporting should be annual or, at most, every six months.

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| 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. |

*BPF response:* We have not, in the time available, been able to provide a numerical estimate. However, we are concerned that the current proposed template is not sufficiently tailored to real estate funds because it calls for data items which are meaningless to them. This will inevitably increase costs to no benefit.

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| 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? |

*BPF response:* We suggest that the deadline should be aligned to the deadline for the production of an annual report under Article 22(1) at four months. If there are different deadlines, this will lead to extra costs to no discernable benefit in the context of real estate funds which do not pose systemic risk.

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| 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? |

*BPF response:* Subject to our comments above about the definition of leverage. We support ESMA's proposed approach in relation to the assessment of whether leverage is employed on a substantial basis.