

ESMA's draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive

Association of Investment Companies (AIC) submission

The AIC welcomes the opportunity to comment on ESMA's draft technical advice. The draft advice raises a significant number of important issues which will influence the effectiveness and proportionality of the AIFM Directive. Time and resource constraints mean that this response is focussed primarily on the issues of most significance to investment companies and their shareholders.

Investment companies are closed-ended collective investment vehicles whose shares are traded on public markets. They are overseen by a board of directors and offer their shareholders access to a diversified portfolio of assets. Asset classes held by the sector include listed and private equity, venture capital, gilts and corporate bonds, property and derivatives.

The AIC represents 350 members with assets of some €95 billion. Some of these are large (with portfolios valued at over €1 billion) but many are smaller companies, including a significant number of venture capital trusts with assets of only a few tens of millions of Euros.

Given this, the AIC's priorities have been to comment in detail on proposals which:

- particularly affect closed-ended funds whose shares are traded on public markets; or
- threaten disproportionate compliance obligations which will increase costs and permanently reduce investment returns but which may deliver little or no compensating regulatory benefit.

Questions raised by the consultation and additional comments on draft guidance

In addition to answering questions raised by the paper this submission also comments on aspects of the draft guidance which raise issues but where no specific question has been asked.

Q 1. 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?

No.

Q 2. Do you think there is merit in ESMA specifying a single date, for example 31 December for the calculation of the threshold?

No. The AIC recommends that a single date should not be adopted. Many AIFM (and AIFs) will already have a regular reporting timetable which may not fit with any single prescribed date. For example, investment companies traded on EU regulated markets already have reporting obligations for annual and half-yearly reports and accounts. The rules allow year ends of different companies to be distributed throughout the year. Creating a single deadline would add additional reporting obligations outside of the existing reporting cycle, with little regulatory value but with significant compliance cost.

It is also likely that creating a single date for the calculation of the threshold will impair regulatory effectiveness. It would result in competent authorities receiving substantial amounts of material from all relevant AIFM in one short period. Inevitable resource constraints will reduce their ability to verify, and otherwise consider, information provided. This burden will be significantly reduced, and the quality of regulatory oversight enhanced, if no single date is set.

As with other aspects of implementing the level 1 text, the requirements for reporting should accommodate the requirements of the Transparency Directive for those AIFM which already report against its provisions.

Q. 3 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.

Yes, the annual net asset value calculation is appropriate and the AIC recommends that it be adopted.

Q. 4 Can you provide examples of situations identified by the AIFM in monitoring the total value of assets under management which would necessitate a re-calculation of the threshold?

The implication of requiring an annual net asset value calculation is that there should not be an obligation to maintain a 'running' NAV calculation. Instead the requirement should be for an additional NAV calculation if an event might reasonably be considered likely to increase the assets under management to the extent that the threshold is breached. Relevant events would be:

- the adoption of gearing by a previously un-g geared AIF;
- the acquisition of a new AIF contract or launch of a new AIF by an AIFM;
- the merger of an AIF with an AIF not currently managed by the AIFM;

- an issue, or sequence of issues, of new shares by an AIF which raises capital which, when added to the previous NAV used for assessment against the threshold, would breach the threshold.

The AIC **recommends** that an AIFM's obligation to recalculate its NAV for the purpose of assessing its position against the thresholds set out in Article 3 should be limited to these situations.

Q. 5 Do you agree that AIFs which are exempt under Article 61 of the Directive should be included when calculating the threshold?

The AIC has no comments on this question.

Q. 6 Do you agree that AIFMs should include the gross exposure in the calculation of the value of assets under management when the gross exposure is higher than the AIF's net asset value?

Yes.

Q. 7 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.

Yes.

Q. 8 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?

Yes, the requirements are generally appropriate. However, box 1 5(b) says that a situation where the total assets exceed the thresholds will not be a temporary event where it continues for a period over 3 months. This is too short a period and it would be disproportionate for this to trigger a requirement for full AIFM authorisation. The AIC **recommends** that this period be set at 6 months.

Comment on box 3: The content of proposed disclosures is sensible and proportionate. However, the proposal for quarterly disclosure is not proportionate and should not be included. (We note that annual disclosure is put forward as sufficient in the relevant explanatory text).

AIFM falling within the exemption provided in Article 3 are not systemic. There is no reason for these entities to report to the competent authority on a quarterly basis. It is unclear what use the competent authorities will make of this information. The provision of high volumes of information of tangential regulatory value will absorb regulatory resources and threaten to compromise, rather than enhance, standards of regulatory oversight. An annual reporting requirement would not prevent individual competent authorities requiring more

frequent reporting if they felt that market circumstances merited enhanced disclosures.

The AIC **recommends** that regular reporting requirements should be limited to once every 12 months and this should be made clear in the final guidance.

Q. 9 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?

The scope of coverage proposed is problematic as it could require risks to be covered which are the responsibility of third parties. Where a problem arises with a supplier performing delegated functions then that supplier will have its own insurance and the AIFM will be able to take action against it for any professional negligence. There should be no requirement for an AIFM to overlay its own insurance with that already taken out by its service providers. This would significantly increase costs for no regulatory value and without delivering additional consumer protection. The AIC **recommends** that the guidance makes clear that risks need not be insured where they fall within the responsibility of a supplier. This should include amending the reference to 'legal responsibility' which is currently included in the opening sentence of paragraph 2.

The problem of 'double coverage' would arise if insurance were required to cover improper valuation of assets. The AIC **recommends** that liability for improper valuation performed by an external valuer should not be included. The AIFM should be liable if it has negligently selected a valuer (e.g. without doing sufficient due diligence). On the other hand, if this selection has been made on a reasonable basis, with proper checks undertaken, the AIFM should not be liable. If an incorrect valuation gives rise to damages which require restitution the AIFM itself should take the matter up with the valuer, including seeking legal redress if appropriate.

Comment on box 7: We anticipate that the reference to a 'historical loss database' which requires recording of loss experience refers to a requirement to record any situations where a loss arose as a result of an operational failure. There may be a risk that this could be interpreted as requiring recording of any losses experienced, for example, even those arising as a result of normal investment activity. This wider interpretation would be inappropriate and disproportionate. We **recommend** that the guidance be clarified to require recording only of material losses arising from significant operational failures.

Comment on box 8: Option 1 is a simple and clear requirement. We envisage many AIFM will chose to adopt this approach because it is straightforward and proportionate. We anticipate that both options are to be made available to an AIFM considering how to fulfil its obligations under Article 9. Our **recommendation** is that both options be allowed. If there is

any prospect that only one of these options is to be made available, the AIC **recommends** that option 1 should be retained in preference to option 2.

Q. 10 Please note that the term ‘relevant income’ used in Box 8 includes performance fees received. Do you consider this as feasible and practicable?

Yes. If there were any problems for AIFM they could instead choose to follow option 1 (see comments above).

Q. 11 Please note that the term ‘relevant income’ used in Box 8 does not include the sum of commission and fees payable in relation to collective portfolio management activities. Do you consider this as practicable or should additional own funds requirements rather be based on income including such commissions and fees (‘gross income’)?

Yes, this is practicable.

Q. 12 Please provide empirical evidence for liability risk figures, consequent own funds calculation and the implication of the two suggested methods for your business. When suggesting different numbers, please provide evidence for this suggestion.

The AIC has no comments on this question.

Q. 13 Do you see practical need to allow for the ‘Advance Measurement Approach’ outlined in Directive 2006/48/EC as an optional framework for the AIFM?

The AIC has no comments on this question.

Q. 14 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?

Allowing the competent authority to authorise a lower percentage is an appropriate approach. An assessment based on a five year historical perspective is appropriate and the AIC **recommends** that this timeframe be adopted.

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 AIF with fewer than 30 investors)? Where there are more than 30 investors, the amount in paragraph 3 (b) would be increased e.g. to €3.5m, while for more than 100 investors, the amount in paragraph 3 (b) would be increased e.g. to €4 m.

No. The amounts set out in box 9 are appropriate. The AIC recommends that the current proposal is included in the guidance unchanged. In particular, it recommends that there should be no adjustments made according to the number of investors.

Q. 16 Paragraphs 4 and 5 of Box 11 set out additional due diligence requirements with which AIFMs must comply when investing on behalf of AIFs in specific types of asset e.g. real estate or partnership interests. In this context, paragraph 4(a) requires AIFMs to set out a ‘business plan’. Do you agree with the term ‘business plan’ or should another term be used?

The Commission is seeking advice from ESMA on criteria which competent authorities should use to assess whether AIFM are complying with their obligations. The proposal in box 11 goes beyond that remit and establishes additional, disproportionate due diligence obligations. Specifically, paragraphs 4 and 5 establish requirements which are too detailed and unnecessary to achieve the objectives set at level 1. Paragraphs 1 – 3 are sufficient and proportionate and will deliver proper compliance. The AIC recommends that paragraphs 4 and 5 be deleted from the proposed guidance.

Paragraph 4 is also inappropriate as the term ‘business plan’ is unsuitable. If any provisions were to be included in the final guidance, the AIC recommends that the term ‘investment policy’ is used instead of ‘business plan’. Also, consequential references to ‘plan’ included in the guidance should be changed to ‘policy’.

The explanatory text for box 11 also indicates that an AIFM must keep records (potentially for five years) of any due diligence carried out for significant investment opportunities which are not completed. This is an excessive obligation, with no consumer or regulatory value. The AIC recommends that this obligation not be included in the due diligence guidance.

Q. 17 Do you agree with Option 1 or Option 2 in Box 19? Please provide reasons for your view.

For the avoidance of doubt, whichever option is adopted, the AIC recommends that any guidance on fair treatment included at level 2 recognises that investors in separate share classes (with specified, but different, rights and entitlements) of the same AIF can be treated differently according to the relevant conditions attached to each share class.

The existence of separate share classes is acknowledged in the explanatory text (paragraph 34) but the position in respect of different classes of shareholder is not clear. The text makes reference to 'material disadvantage to investors' but does not acknowledge that differences in treatment are acceptable where different rights and entitlements are set out in the AIF's constitutional arrangements. The AIC **recommends** that this is explicitly addressed in the guidance itself.

Subject to this amendment, the AIC **recommends** that option 1 be adopted.

Comment on box 23: The level 1 text already restricts marketing of AIFs to retail investors, except where a Member State has allowed it. There is no risk that institutional investors would not have access to the internet. Under the obligations set out in level 1 they will also be able to secure information in relation to their investments where they require it. Paragraph 3 of box 23 reflects the requirements customarily applied to point of sale disclosures for retail investors. They are not proportionate or required in the context of a directive aimed at institutional investors.

Also, investment companies trade their shares on public markets. Their shareholder registers change on a regular basis. Investment companies already have significant disclosure obligations which can be discharged through website disclosure. For example, the Transparency Directive allows disclosures (including the distribution of the annual report) via a website where certain approvals are secured. This information is highly significant to investors and for the maintenance of orderly public markets. It has substantial regulatory significance. Nevertheless, it is accepted that website publication is a suitable mechanism for disclosure if appropriate processes are observed. These processes are far more workable and proportionate than those envisaged in paragraph 3 of box 23.

In particular, approval for electronic communication under the Transparency Directive does not require specific consent. A company is required to seek approval from shareholders. If a particular shareholder does not object within a reasonable timeframe then consent is considered to be given. Also, once consent has been given then the company can continue to rely on that consent (even though there may have been a change in the underlying shareholder register). As a safeguard for individual shareholders, the company is required to provide shareholders with a paper report if requested. This is a proportionate and workable system.

The AIC **recommends** that paragraph 3 of box 23 be deleted and replaced with provisions reflecting the arrangements set out above. The AIC **recommends** that they should be compatible with the requirements of the Transparency Directive.

Specifically, it **recommends** that:

- specific consent and evidence that a shareholder has access to the internet should not be required.
- consent of individual shareholders should be presumed if no objection is raised.
- once consent has been secured, then the AIFM should be able to rely on this consent.
- to safeguard individual investor rights, individuals should be able to request hard copies of the required disclosure.

Comment on box 24: The Commission is required to specify types of conflicts of interest which may arise under Article 14 of the AIFMD and set out the reasonable steps which an AIFM might take to deal with these.

While the exercise of voting rights could be a significant issue for some AIFM, it will not be relevant for all. The proposals set out in box 24 are disproportionate and overly detailed. The AIC **recommends** that ESMA's guidance on the exercise of voting rights should be limited to the provisions set out in paragraph 1 and that paragraphs 2 and 3 of box 24 should be deleted.

Also, the explanatory notes suggest that non-exercise of voting rights should only be permitted if this is to the 'exclusive benefit' of the AIF and its investors. Deliberate non-voting where that creates a conflict of interest would be prevented under the approach recommended above. There should be no implication that an AIFM cannot, as a matter of general policy, choose not to vote shares.

Comment on box 28: Measurement and management of risk is a central role for the AIFM. The measures set out in paragraph 1 of box 28 are appropriate to deliver the desired regulatory outcome. It is also welcome that paragraph 2 recognises the principle of proportionality.

The requirements set out in paragraph 3 are disproportionate. It will not be appropriate for all AIFM to undertake all of the measures set out in sub-paragraphs (a) – (f). The AIC **recommends** that paragraph 3 be amended so that the processes set out in sub-paragraphs (a) – (f) are possible measures which an AIFM could adopt to demonstrate that it has complied with the requirements of paragraph 1. The AIC **recommends** that the guidance acknowledges that specific arrangements adopted may vary according to the nature, size and complexity of the AIFM.

Q. 18 ESMA has provided advice as to the safeguards that it considers AIFM may apply so as to achieve the objective of an independent risk management function. What additional safeguards should AIFM employ and will there be any specific difficulties applying the safeguards for specific types of AIFM?

No additional safeguards are required. On the contrary, the AIC is concerned that ESMA's proposed advice is too restrictive and fails to address the Commission's request. CESR [ESMA] was requested to advise, "*how the principle of proportionality is to be applied by competent authorities in reviewing the functional and hierarchical separation of the functions of risk management in accordance with Article 15 (1).*" The draft advice included in box 30 does not provide insight into developing a proportionate approach. Instead it sets out an onerous list of conditions (in paragraph 1) which is highly prescriptive and goes beyond that which is required to secure functional and hierarchical separation. Paragraph 3 of box 30 does potentially mitigate some of the requirements of paragraph 1 "*where compliance cannot be achieved*". However, taken as a whole, box 30 does not offer a proportionate or coherent regulatory approach.

Instead of adopting the approach set out in box 30, the AIC **recommends** the AIFM should be required to demonstrate to the competent authority that it has functionally and hierarchically separated the risk management function. The criteria listed in paragraph 1 (a – e) should be highlighted as measures which will be indicative of achieving suitable arrangements. The AIC **recommends** that measures identified in paragraph 3 are included as indicators of possible routes to compliance. This will deliver the level 1 text's requirement for separation but also ensure proportionality, which was the key request made by the Commission.

Also, paragraph 5 of box 26 sets out the principle that AIFM should, "*take into account the nature scale and complexity of their business and the AIF it manages*". This is an important mechanism to deliver proportionality and the AIC **recommends** that it should be applied to all the proposed guidance on risk issues, in particular in relation to the functional and hierarchical separation of the risk management function. Currently this provision is only applied to part of the draft guidance set out in box 30. The AIC **recommends** that this principle is applied to all the guidance on functional and hierarchical separation of the risk management function.

Q. 19 ESMA would like to know which types of AIFM will have most difficulty in demonstrating that they have an independent risk management function? Specifically what additional proportionality criteria should be included when competent authorities are making their assessment of functional and hierarchical independence in accordance with the proposed advice and in consideration of the safeguards listed?

See answer to question 18.

Q. 20 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?

The AIC has no comments on this issue.

Q. 21 AIFMs which manage AIFs which are not closed ended (whether leveraged or not) are required to consider and put into effect any necessary tools and arrangements to manage such liquidity risks. ESMA's advice in relation to the use of tools and arrangements in both normal and exceptional circumstances combines a principles based approach with disclosure. Will this approach cause difficulties in practice which could impact the fair treatment of investors?

The AIC has no comment on this issue.

Q. 22 Do you agree with ESMA's proposed advice in relation to the alignment of investment strategy, liquidity profile and redemption policy?

Box 32 recognises that the obligations applying to leveraged closed-ended AIF should differ from those relevant for other funds. This is welcome but the text does not say that a closed-ended AIF need not comply with the requirements of paragraph (e) which deals with redemption policies. We anticipate that this is a drafting error as closed-ended funds do not have redemption policies. The AIC **recommends** that part 1 of box 33 be adjusted so that paragraph (e) is included in the provisions which leveraged closed-ended funds need not comply with.

The AIC has no other comments on this issue.

Comment on box 50: There is a need for proper processes to review an AIFM's systems, internal control mechanisms and arrangements. However, this will already be achieved by the compliance function described in box 49. The provisions in box 50 are unnecessary and far too detailed for level 2 measures. This is implicitly recognised by the caveat included in the draft guidance which says that such an internal function only need be established '*where appropriate*' depending on the nature, scale and complexity of the business. To remove the risk that overly detailed and prescriptive requirements are introduced at level 2 the AIC **recommends** that box 50 be deleted from the proposed guidance.

Comment on box 52: Recording portfolio transactions provides important regulatory information and may help ensure that the interests of investors are upheld. However, the provisions set out in box 52 are overly complex and do not take account of the variety of AIFM that may be required to keep records or the type of assets which they are dealing in.

For example, an AIFM which is also the AIF is managing its own money on behalf of its own shareholders. This reduces the risk that dealing practices would create conflicts of interest or raise other problems that might require scrutiny at a later date. Also, an AIFM may transact in assets such as property or private equity which do not lend themselves to the recording obligations set out. The AIC therefore **recommends** that paragraph 2 of box 52 should not be compulsory. Instead the AIC **recommends** that paragraph 2 (a) – (i) be included as an indicative list of information which might be recorded to fulfil the requirements of paragraph 1.

The AIC also **recommends** that guidance makes explicit that the nature, structure and complexity of the AIFM, and the assets traded, be taken into account when considering what information needs to be included in any record taken.

Comment on box 56: Paragraph 2 suggests that the valuation model should be ‘validated’. It is not clear what this requirement implies. This obligation is overly prescriptive and not required for the purposes of ensuring compliance with the level 1 text. However, the requirement for senior management to approve the valuation model is appropriate. The AIC **recommends** deleting the references to validation in paragraph 2 and instead only requiring senior management to approve the valuation model.

Q. 23 Should a requirement for complaints handling be included for situations where an individual portfolio manager invests in an AIF on behalf of a retail client?

No. The AIC **recommends** that such a mechanism is not appropriate.

Comment on box 63: More clarity on tasks of critical importance should be included. In particular, many AIFM will use external suppliers to provide and maintain IT systems. These systems will often have some degree of customisation so might not be standard software ‘off the shelf’. Clearly IT failures could be relevant to the operation and continuing compliance of the AIFM (as, incidentally, could legal advice). Nevertheless, we do not feel that the appointment of IT suppliers should be subject to regulatory oversight. The AIC **recommends** that IT suppliers and similar support should be clearly designated as providers of ‘supporting tasks’ in accordance with Recital 22 and not subject to the delegation rules.

Also, while it is helpful that the provision of legal services is highlighted in paragraph 3(a), it would also be useful to mention other professional services which may be procured as standard by an AIFM. The AIC **recommends** that the provision of “accounting, audit, marketing and corporate finance” advice be added to the draft guidance.

Comment on box 64: Where any aspect of portfolio management is delegated it must be carried out in accordance with the investment policy. That said, the act of delegation will often give the delegate discretion within

certain boundaries. After all, one of the purposes of delegation will be to gain access to the expertise of the third party.

Paragraph 1(h) states that the delegate should ‘*be instructed by the AIFM how to implement the investment policy.*’ The wording of the guidance should make clear that suitable discretion is allowed. The AIC **recommends** adjusting the second sentence of 1(h) to say, “*The delegate should be instructed by the AIFM how to implement the investment policy, but may exercise discretion within the scope of these instructions.* The AIFM should monitor ...” [recommended wording underlined.]

Also, in paragraph 1(f) the word ‘guaranteed’ is not suitable. The AIC **recommends** that it be replaced by ‘maintained’, which more properly describes the outcome the AIFM should seek to secure.

Q. 24 Do you prefer Option 1 or Option 2 in Box 65? Please provide reasons for your view.

The AIC **recommends** that option 2 be adopted. It sets out a number of the key reasons why delegation might be used. All of these are justified reasons and have the capacity to enhance outcomes for shareholders. Option 2 nevertheless recognises that there might be other satisfactory justifications for delegation and allows for this by making the list indicative.

Option 1 is not preferred as it does not provide as much clarity on what might be suitable justifications. The concept of ‘efficient conduct’ would encompass all those listed in option 2 but making these options clear increases the value of providing clarification at level 2.

Alternatively, the AIC **recommends** that the options could be combined and used in the guidance. This approach would mean including the principle set out in option 1 and illustrating it with the list of bullets set out in option 2.

Comment on box 66: The provisions set out in paragraph 4 are too onerous. It would not be credible for an AIFM to definitively satisfy itself that there are no ‘negative records’ regarding the reputation of a potential delegate. While an AIFM will have to undertake satisfactory due diligence and seek relevant assurances, the provisions set out in paragraph 4 are inappropriate and the AIC **recommends** that they be deleted.

Also, the guidance should allow an AIFM to rely on existing regulatory approvals. Therefore, the AIC **recommends** that the guidance be amended to state that a third party may be assessed to be suitable to undertake delegated tasks where they are regulated under existing regulatory frameworks, including UCITS and MiFID and equivalent non-EU regimes. This is a proportionate approach which will deliver an effective regulatory outcome.

Comment on box 71: Delivering a suitable and proportionate regime should be ESMA's key priority. With this in mind the AIC supports the comment in the explanatory text for box 71 (paragraph 44, page 134) which says that functional and hierarchical separation should be calibrated to the nature, scale and complexity of the sub-delegate. The AIC **recommends** that this principle be included in the draft guidance itself as this will help deliver a proportionate outcome.

Comment on not providing a model agreement: The AIC agrees with ESMA's justification for not providing a model agreement and agrees with the approach proposed.

Q. 25 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?

The AIC **recommends** that this requirement should not be imposed. It is not necessary to achieve the requirement for a depositary to monitor an AIF's cash position. The oversight obligations as set out in box 76, option 2 will achieve the desired result. The requirement to open an account would go beyond the obligations required by the level 1 text and inappropriately restrict distribution options.

Q. 26 At what frequency is the reconciliation of cash flows performed in practice? Is there a distinction to be made depending on the type of assets in which the AIF invests?

We anticipate that most investment companies reconcile their cash positions at least on a monthly basis – many will reconcile daily. N.B. As closed-ended funds these entities do not have to cater for regular subscriptions and redemptions of shares. Where an investment company is issuing shares it may undertake additional reconciliations as required.

Q. 27 Are there any practical problems with the requirement to refer to Article 18 of MiFID?

No.

Q. 28 Does the advice present any particular difficulty regarding accounts opened at prime brokers?

The AIC has no comments on this question.

Q. 29 Do you prefer option 1 or option 2 in Box 76? Please provide reasons for your view.

The approach set out under option 1 is disproportionate, particularly the proposal for a system to 'mirror' transactions and periodically reconcile cash account statements. This approach goes further than required by the level 1

text and will not secure a cost effective approach to delivering the depositary's cash monitoring obligations. The requirement for an AIF to have an account with the depositary is also unnecessary to deliver the requirements at level 1. It will not be practical for an AIFM to ensure that instructions are sent 'simultaneously' to a depositary. Establishing systems would be particularly difficult where multiple bank accounts were involved. The AIC **recommends** that ESMA's guidance should not adopt option 1.

Option 2 in box 76 establishes a more proportionate and workable approach to cash monitoring. The emphasis on proper procedures reflects the established approach taken in respect of other depositary obligations, reduces duplication in the oversight processes (for example, the role of the auditor) and will establish an effective and cost effective compliance obligation. The AIC **recommends** that option 2 is adopted.

Q. 30 What would be the estimated costs related to the implementation of option 1 or option 2 of Box 76?

There is insufficient policy justification for introducing option 1. It also falls outside the scope of the level 1 requirements. Additionally, this approach would be more complicated and expensive to introduce. We anticipate the costs would be significant. Any incremental increase in costs without sufficient policy justification is unacceptable under principles of good regulation. Option 1 cannot be justified on a cost benefit basis.

Q. 31 What would be the estimated costs related to the implementation of cash mirroring as required under option 1 of Box 76?

There is insufficient policy justification for introducing option 1. Including a cash mirroring requirement falls outside the scope of the level 1 requirements. Additionally, this approach would be complicated and expensive. Any incremental increase in costs without sufficient policy justification is unacceptable under principles of good regulation. Option 1 cannot therefore be justified on a cost benefit basis.

Q. 32 Do you prefer option 1 or option 2 in Box 78? Please provide reasons for your view.

The AIC prefers option 2 and **recommends** that it be adopted.

Q. 33 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?

The AIC has no comments on this question.

Q. 34 How easy is it in practice to differentiate the types of collateral defined in the Collateral Directive (title transfer / security transfer)? Is there a need for further clarification of option 2 in Box 79?

The AIC prefers option 3 and **recommends** that it be adopted.

Q. 35 How do you see the delegation of safekeeping duties other than custody tasks operating in practice?

The AIC has no comments on this question.

Q. 36 Could you elaborate on the differences notably in terms of control by the depositary when the assets are registered directly with an issuer or a registrar (i) in the name of the AIF directly, (ii) in the name of the depositary on behalf of the AIF and (iii) in the name of the depositary on behalf of a group of unidentified clients?

The AIC has no comments on this question.

Q. 37 To what extent would it be possible / desirable to require prime brokers to provide daily reports as requested under the current FSA rules?

The AIC has no comments on this question.

Q. 38 What would be the estimated costs related to the implementation of option 1 or option 2 of Box 81? Please provide an estimate of the costs and benefits related to the requirement for the depositary to mirror all transactions in a position keeping record?

Transaction mirroring is not required to deliver the obligations set out in the level 1 text and creates no additional value for investors. It would cost more than option 1 and it cannot be justified on a cost benefit basis. The AIC therefore **recommends** adopting option 1.

Comment on box 82: The depositary should not be required to assess the risks associated with the AIFM. This goes further than the requirements of the level 1 text. It also undermines the AIFM's own fiduciary and regulatory duties as it is the AIFM (not the depositary) which is responsible for establishing its procedures and ensuring compliance with the directive. Any obligation of this nature risks significantly increasing the scope of the depositary's liability and would increase its exposure to risk and the cost it would charge clients. This risks lower investment returns for no regulatory benefit – the AIFM is already responsible for these issues. The AIC therefore **recommends** deleting paragraph 1 of box 82.

Also, in paragraph 2, the AIC **recommends** that the depositary's role in overseeing third parties is limited to considering the appointment process for those entities performing significant regulatory functions. The level 2 text should recognise the AIFM's own responsibility for monitoring the processes

of third parties. The depositary should not be placed in a position where it has to either second guess or duplicate work which is properly the regulatory responsibility of the AIFM.

Comment on box 83: Paragraph 56 of the explanatory note on box 83 says that the depositary should be responsible for monitoring the distribution of shares in an AIF. Investment company shares are traded on secondary markets, where transactions are undertaken between shareholders without the participation of the AIF or AIFM. The AIC **recommends** that the guidance should make clear that the depositary does not have any obligations in respect of share transactions unless the AIF and/or the AIFM are directly involved.

Q. 39 To what extent does / should the depositary look at underlying assets to verify ownership over the assets?

The AIC has no comments on this question.

Q. 40 To what extent do you expect the advice on oversight will impact the depositary's relationship with funds, managers and their service providers? Is there a need for additional clarity in that regard?

The AIC has no comments on this question.

Q. 41 Could potential conflicts of interest arise when the depositary is designated to issue shares of the AIF?

The AIC has no comments on this question.

Q. 42 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?

The AIC supports ESMA's view that depositary oversight in respect of sales of units or shares should only apply where the AIF or AIFM is involved. The AIC **recommends** that the guidance makes clear that oversight is not be required for transactions on secondary markets, for the reasons set out in the consultation paper.

The need for the clarification recommended above highlights the fact that the precise obligations of the depositary will vary according to the legal structure of the AIFM it is employed by. The AIC **recommends** that the guidance on the depositary's oversight duties, set out in box 82, says that the precise details of the depositary's role will depend on the nature, scale and complexity of the AIFM and the AIF it manages. Setting out a definitive approach risks not delivering sufficient and proportionate oversight for all types of AIFM and investment strategy. Including a general provision of this nature will ensure

that unnecessary obligations are avoided while creating an onus for oversight of issues where specific guidance has not been set out.

Q. 43 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?

The requirement should not extend beyond sales of shares or units undertaken by the AIFM itself. It would not be practical for a depositary to have oversight of share transactions which did not involve the AIFM or AIF.

Q. 44 With regards to the depositary's duties related to the carrying out of the AIFM's instructions, do you consider the scope of the duties set out in paragraph 1 of Box 85 to be appropriate? Please provide reasons for your view.

The provisions set out in box 85 risk extending the depositary's role into areas which are more properly the duty of the AIFM. The AIFM itself should be responsible for on-going monitoring of its investment restrictions and leverage. The risk that the current draft of the guidance might draw the depositary into on-going risk monitoring is acknowledged in paragraph 61 of the explanatory note.

There should be no suggestion in the final guidance that the depositary has a role as part of the investment process. Its role should be strictly limited to checks after the transaction. The final guidance should make clear that any checking of investments against the investment strategy is not a 'real-time' obligation and that there is no requirement for checks in advance of a transaction being completed. Such checks would be disproportionate and impracticable, particularly for funds invested in quoted shares. Such an obligation is not required for UCITS and should not be required here. A requirement of this nature would be disproportionate, costly and outside the intention of the depositary role.

We note similar concerns in the requirement for oversight of leverage limits. There should be no question that obligations in this area should be real-time. The AIC **recommends** that this also be made clear in the guidance.

Overall we **recommend** that the guidance on depositaries should be reviewed to ensure that the role of the depositary is limited to that envisaged at level 1 and that it does not seek to either duplicate or undermine the role undertaken by the AIFM. The AIFM will be a directly regulated party with its own fiduciary and regulatory role. As such it will have its own clear obligations. It would be disproportionate and inappropriate to establish rules which potentially make the depositary liable for any problems which the level 1 text makes exclusively the responsibility of the AIFM. To do so will duplicate activity and increase depositary risks in a way which will substantially increase costs without delivering any significant investor or regulatory benefits.

Q. 45 Do you prefer option 1 or option 2 in Box 86? Please give reasons for your view.

The AIC prefers option 1 and recommends it be adopted. There is no need for clarification on this issue and the approach set out in option 2 creates an unnecessary compliance burden.

Comment on box 87: It is for the AIFM (not the depositary) to respond to issues raised by the auditors. The depositary should have no obligations in this area and the AIC therefore recommends that paragraph 2 of box 87 should be deleted.

Q. 46 What alternative or additional measures to segregation could be put in place to ensure the assets are ‘insolvency-proof’ when the effects of segregation requirements which would be imposed pursuant to this advice are not recognised in a specific market? What specific safeguards do depositaries currently put in place when holding assets in jurisdictions that do not recognise effects of segregation? In which countries would this be the case? Please specify the estimated percentage of assets in custody that could be concerned.

The AIC has no comments on this question.

Q. 47 What are the estimated costs and consequences related to the liability regime as set out in the proposed advice? What could be the implications of the depositary’s liability regime with regard to prudential regulation, in particular capital charges?

The more stringent the liability regime, the greater the implied risk for depositary providers. Even remote risks will have to be taken into consideration in the arrangements implemented by depositaries (e.g. through insurance or increased capital requirements). This will result in higher costs for AIFM, which will be passed onto investors in each and every AIF. A balance needs to be struck between providing meaningful protection for consumers and imposing costs which will act as a permanent drag on investment performance.

The implications of increasing costs should not be underestimated. The original proposal for a Directive estimated that €2 trillion is managed by AIFM employing a variety of investment techniques. Even a one basis point increase in costs because of increased liability risks implies an additional annual cost of €200m. It seems likely that the liability regime for AIFM depositaries will also have implications for the UCITS market. The potential drag on investor returns would be even greater. This increases the importance of developing a proportionate solution which delivers outcomes which will really benefit consumers. The higher the liability imposed on depositaries, the less likely it is that this outcome will be achieved.

Q. 48 Please provide a typology of events which could be qualified as a loss in accordance with the suggested definition in Box 90.

The AIC has no comments on this question.

Comment on box 91: The proposed guidance should be clarified to appropriately limit the depositary's role and to clarify their obligations.

In particular, paragraph 3 (a) - (c) risks placing the depositary in a situation where it is required to second-guess the investment expertise of the AIFM. It requires the depositary to identify 'external events' which may present a significant risk of loss of the instrument. This could require a depositary to, say, take a view on the political situation in a particular market where it has no experience. On the other hand, the AIFM is already required to have investment expertise in such markets (this is a condition for it being the AIFM, see Article 8. 1.c of the level 1 text). The AIFM's investment strategy may require exposure to markets where risks of loss of assets are part and parcel of the investment proposition. The depositary should not be put in a position where it should seek to second-guess or direct the activity of the AIFM. The depositary should not be required to try and eliminate risks of this nature. The requirements as set out are disproportionate and inappropriate and the AIC therefore **recommends** that paragraph 3 of box 91 be deleted.

Q. 49 Do you see any difficulty with the suggestion to consider as an external event the fact that local legislation may not recognise the effects of the segregation requirements imposed by the AIFMD?

The AIC has no comments on this question.

Q. 50 Are there other events which should specifically be defined/presumed as 'external'?

The AIC has no comments on this question.

Q. 51 What type of event would be difficult to qualify as either 'internal' or 'external' with regard to the proposed advice? How could the 'external event beyond reasonable control' be further clarified to address those concerns?

The AIC has no comments on this question.

Q. 52 To what extent do you believe the transfer of liability will / could be implemented in practice? Why? Do you intend to make use of that provision? What are the main difficulties that you foresee? Would it make a difference when the sub-custodian is inside the depositary's group or outside its group?

The AIC has no comments on this question.

Q. 53 Is the framework set out in the draft advice considered workable for non-bank depositaries which would be appointed for funds investing mainly in private equity or physical real estate assets in line with the exemption provided for in Article 21? Why? What amendments should be made?

The AIC has no comments on this question.

Q. 54 Is there a need for further tailoring of the requirements set out in the draft advice to take into account the different types of AIF? What amendments should be made?

The AIC has no comments on this question.

Comment on Boxes 93 – 99: The various methodologies set out are complex and understanding their precise implications for specific situations is highly challenging.

Nevertheless, the AIC is very concerned that the calculation of leverage in accordance with the AIFM Directive should not lead to public disclosures which will confuse investors. Investment companies already calculate and publish figures on leverage. These disclosures are designed to help investors understand the risks they are exposed to. Where an investment company's shares are traded on EU regulated markets this information is published in accordance with the requirements of the Transparency Directive, which includes mechanisms and regulatory sanctions to ensure that the market is not misled. This approach is designed to ensure that investors receive an accurate picture of the risks facing the company. Leverage disclosures are taken very seriously by investment companies and the market has strong expectations and demands for what should be disclosed.

On the other hand, the AIFM Directive's concern with leverage has two functions. One is to inform investors. The other is to provide competent authorities with information required to monitor systemic risks. This systemic objective is likely to result in an assessment of leverage which differs significantly from the perspective taken by investors. For example, investors are likely to view currency hedging arrangements as a mechanism which limits their investment risk. Competent authorities considering the same issue may be more concerned that it increases the overall exposure of the financial system to potential counterparty risks. The range of issues the AIFM Directive is seeking to cover is likely to mean that the calculation of leverage for regulatory purposes will diverge from the disclosures investors are currently receiving.

The AIC **recommends** that careful consideration should be given both to the calculation of exposure to leverage and how this information is used. The risk is that the 'regulatory' calculation will be more or less meaningless to investors but that this figure may have to be published. This risks obscuring important information which investors currently use to make their investment decision. It could create conflicts with leverage disclosures currently made under the

Transparency Directive which are designed to help investors understand the material risks they face when investing in the fund. There should be no possibility that AIFM Directive leverage calculations/disclosures are allowed to undermine other disclosures designed specifically to benefit investors.

Q. 55 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?

The AIC has no comments on this question.

Q. 56 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 this application?

The AIC has no comments on this question.

Q. 57 Is further clarification needed in relation to the treatment of contingent liabilities or credit-based instruments?

The AIC has no comments on this question.

Q. 58 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?

The term 'cash and cash equivalents' is a well understood concept. The reference to 'risk-free rate' of return is unclear. The AIC recommends that the words "*which provide a return at the risk-free rate*" are deleted from paragraph 1(a) of box 95.

Q. 59 Which of the three options in Box 99 do you prefer? Please provide reasons for your view.

The AIC has no comments on this question.

Q. 60 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?

There should be no question that any guidance issued at level 2 should override the policy intention set out in recital 78 of the directive. The draft guidance must recognise this overriding policy position.

Q. 61 Do you agree with ESMA's advice on the circumstances and criteria to guide competent authorities in undertaking an assessment of the extent to which they should impose limits to the leverage that an AIFM may employ or other restrictions on the management of AIF to ensure the stability and integrity of the financial system? If not, what additional circumstances and criteria should be considered and what should be the timing of such measures? Please provide reasons for your view.

The AIC has no comments on this question.

Q. 62 What additional factors should be taken into account in determining the timing of measures to limit leverage or other restrictions on the management of AIF before these are employed by competent authorities?

The AIC has no comments on this question.

Q. 63 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?

The general approach allows AIFM to report against relevant accounting standards according to their domicile. This is an appropriate approach which the AIC supports. However, the wording of box 102 (2) could imply that the AIF is required to have accounting rules set out in its own rules or instruments of incorporation. This would not be a suitable requirement. Investment companies (and, we anticipate, many other AIFs) do not set out such rules but instead rely on relevant accounting standards. This should be acceptable for the purposes of the Directive.

The AIC **recommends** that the advice should clarify this matter by changing paragraph 2, so it reads, "... *where the AIF is established or, where appropriate, in accordance with the accounting rules laid down in the AIF rules or instruments of incorporation.*" (Replacement word underlined.)

The AIC also **recommends** that ESMA ensure that any level 2 guidance on disclosures in the annual report should not conflict with obligations to make required disclosures in accordance with the Transparency Directive.

Q. 64 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?

The AIC has no comments on this question.

Q. 65 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?

The AIC has no comments on this question.

Q. 66 Do you agree with ESMA's proposed definition of special arrangements? What would this not capture?

The AIC has no comments on this question.

Q. 67 Which option for periodic disclosure of risk profile under Box 107 do you support? Please provide reasons for your view.

The AIC **recommends** that option 1 be adopted. It offers more discretion in making the disclosure and should result in higher quality information being provided to shareholders. This approach will secure a better regulatory outcome.

Q. 68 Do you think ESMA should be more specific on how the risk management system should be disclosed to investors? If yes, please provide suggestions.

No.

Q. 69 Do you agree with the proposed frequency of disclosure? If not, please provide alternative suggestions.

No. Quarterly disclosure is too frequent. It is difficult to see what use the competent authorities will make of these disclosures. The AIC **recommends** that, in normal market conditions, annual disclosure is sufficient. In times of market stress, or other exceptional circumstances, the competent authority would be able to require more frequent reporting from all – or some - AIFM. An AIFM might also be required to make a disclosure if its investment exposure changed materially between annual reports.

Q. 70 What costs do you expect completion of the reporting template to incur, both initially and on an on-going basis? Please provide a detailed analysis of cost and other implications for different sizes and types of fund.

The reporting template is too detailed if quarterly reporting is to be required (although may be suitable for annual disclosure). It will be onerous to complete and submit and is likely to utilise significant administrative resources. It is also unclear how this information would be used if secured on a quarterly basis. While the AIC has no specific figures, its estimate is that the benefit will not outweigh the cost.

Q. 71 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?

No. The deadline is insufficient, particularly as it potentially requires valuation of illiquid assets such as private equity and property. The AIC **recommends** that, for normal reporting purposes, a deadline of 4 months (corresponding to the timetable set out for annual reporting under the Transparency Directive) is allowed.

Q. 72 Does ESMA's proposed advice in relation to the assessment of whether leverage is employed on a substantial basis provide sufficient clarity of AIFMs to enable them to prepare such an assessment?

No. The AIC **recommends** that the guidance should also establish a minimum level where leverage cannot be deemed to be substantial.

The original proposal for a Directive set significant gearing at least 100% of share capital (where leverage exceeded the equity capital of the AIF in at least 2 of the past 4 quarters). Reflecting the original proposal for a Directive, the AIC **recommends** that the minimum level should be set at least 100% gearing.

1 September 2011

For more information on the issues raised in this paper please contact:

Guy Rainbird, Public Affairs Director, The Association of Investment Companies. guy.rainbird@theaic.co.uk