UBS Response to the ESMA consultation on implementing measures of The Alternative Investment Fund Managers Directive

INTRODUCTION

UBS would like to thank ESMA for the opportunity to comment on the consultation paper on Implementing Measures of the Alternative Investment Fund Managers Directive ("the Paper"). Please find below our response to the specific questions set out in the Paper.

PART 1 - GENERAL PROVISIONS, AUTHORIZATION AND OPERATING CONDITIONS

III. Article 3 exemptions

III.1. Identification of the portfolio of AIF under management and calculation of the value of assets under management

Under the AIFMD it is the responsibility of the AIFM to establish whether it must obtain authorization under the AIFMD or whether it can benefit from the exemption under Article 3(2). To do this the AIFM must identify the AIFs under its management and calculate the assets under management ("AuM") of these AIFs.

Calculation of the total value of assets under management

ESMA sets out how to identify the portfolios under management by a particular AIFM, and the calculation of the value of AuM. Specifically ESMA proposes that the total AuM value should be calculated at least annually using the latest available NAV calculation including assets acquired through leverage for each AIF. The latest available NAV for each AIF must be produced within 12 months of the threshold calculation date. The AIFM furthermore must apply a consistent approach to the selection of the annual threshold calculation date and any change to the date chosen thereafter must be justified to the competent authority.

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?

We do not believe that this would be an onerous requirement. We would, however, like to emphasize our view that regardless of the calculation method, delivery of the information

should be coordinated with the annual reporting of the AIF. We would regard requiring an additional valuation to be costly, burdensome and potentially confusing to investors.

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

In our view the date should be left at the discretion of the AIFM. Referring to our comments in Q1 AIFM should be able to coordinate delivery of the information with the annual reporting of the AIF.Specifically for real estate funds the specific date for calculating the threshold is not sensible, because in order to properly determine the NAV the manager relies on the valuation by external experts who determine the market value of the underlying properties. Different factors determine the timing of the issuance of these experts' opinions; as such the date should be left to the discretion of the AIFM.

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.

We believe that the annual NAV calculation is an appropriate measure for all types of AIFs with the exception of infrastructure funds. For the latter using a NAV calculation is workable, but acquisition cost of assets, or commitments less realizations at cost would in our view not only be simpler, but also the more appropriate method to apply. This would also subject less liquid funds to less movement above or below the exemption threshold.

Alternatively ESMA could consider adding a provision to allow AIFMs of such funds which are considered to be above the threshold based on the latest NAV calculation, but where the fund manager in good faith believes the actual asset value of the AIF to be below the threshold, to demonstrate their case.

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

We are not aware of any particular examples which would require recalculation.

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

In our view AIFs which are exempt under Article 61 should not be included when calculating the threshold.

III.2 Influences of leverage on the assets under management

ESMA considers how the use of different forms influences the AuM and how this should be taken into account in the calculation of AuM. Specifically ESMA outlines that AIFM (i) must include assets acquired through leverage when calculating the total value of assets under management and (ii) shall calculate leverage using the Gross method of calculating the exposure of the AIF.

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

Gross exposure should in our view not be included in the calculation of AuM. We would also welcome clarification from ESMA on the definition of assets under management which we understand as the cash received from investors plus accumulated profit and loss. In our view using this measure and stating a leverage ratio would be the preferable approach to take.

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?

Referring to our statements made in Q6, if assets under management are defined as cash received from investors plus accumulated profit and loss, we do not believe that foreign exchange and interest rate hedging positions should be excluded when taking into account leverage for the purposes of calculating the total value of AuM. This is because the NAV includes the value of all positions including hedging positions. As such the value of the hedges (=P&L) will be offset against the value of the trading assets.

As an overall comment, however, we would question the proposed approach due to inability to clearly distinguish between a hedge position and a risk position.

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?

Whilst ESMA's advice is worded in a clear manner, we do not agree that gross exposure should be included in the calculation of AUM. Please refer to our comments in Q6.

III.3 Content of the obligations to register with national competent authorities and suitable mechanisms for gathering information

ESMA considers the content of the obligation to register with national competent authorities and a suitable mechanism for national authorities to gather information. Specifically ESMA outlines that the following information should be provided to competent authorities as part of the registration process: (i) total value of AuM management, (ii) updated information on the investment strategies of the AIFs by providing either the offering document (relevant extract or the full document), or a general description of the investment strategy. The description of the investment strategy has to at least include the main categories of asset in which the AIF will invest; any industrial, geographic or other market sectors or specific classes of asset which are the focus of the investment strategy; and a description of the AIF's borrowing or leverage policy.

III.4 Opt-in procedures

ESMA considers the procedures for AIFM which choose to opt in under the Directive (Box 4 and 5). Specifically ESMA outlines that AIFMs which were previously registered with a competent authority and which elect for authorization should submit all documents set out in Article 7, which have not been previously been submitted for registration purposes provided that there has been no material change to the information previously submitted. AIFMs authorized as a result of being above the threshold who subsequently falls below this threshold should consider notifying the competent authority that it intends to remain authorized under the AIFMD in accordance with the opt-in provisions; or demonstrate that it will remain below the threshold and seek revocation of its authorization.

IV General Operating Conditions

ESMA consults on the description of the types of risks arising from professional negligence as well as methods for calculating the respective amounts of additional own funds or the coverage of the professional indemnity insurance.

IV.1 Possible implementing measures on additional own funds and professional indemnity insurance

1) Description of potential risks arising from professional negligence to be covered by additional own funds or professional indemnity insurance

According to ESMA the AIFM must be able to cover the potential liabilities arising from professional negligence. The potential liability risks to be covered are the risk of losses arising from the activities of the AIFM for which the AIFM has legal responsibility. Those are particularly:

(a) Risks in relation to fraud,
(b) Risks in relation to investors, products & business practices which include losses due to dishonest, fraudulent or malicious acts by relevant persons as well as losses arising from a negligent failure to meet a professional obligation to specific investors and clients. The latter risks include (i) negligent loss of documents evidencing title of assets of the AIF, (ii) misrepresentations and misleading statements made to the AIF or its investors by the AIFM or relevant persons and (iii) negligent acts, errors or omissions by the AIFM resulting in a breach of obligations according to law and regulatory framework, duty of skill and care to the AIF when carrying out its professional activities, obligations of confidentiality, AIF rules or instruments of incorporation and terms of its appointment by the AIF; (iv) improper valuation of assets and calculation of unit/share.
(c) Risks in relation to business disruption, system failures, process management.

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?

We do not consider this a feasible and practical proposal for a number of reasons. First, the AIFM should not be made liable for third parties' misconduct, especially if they must act independently from the AIFM by law. Second, it would be very difficult and expensive for

the AIFM to find a liability insurance to cover for damages caused by third parties misconduct. At most, AIFM can be made liable for the choice of sufficiently qualified experts and of course for calculations of share prices performed by them.

Overall we believe that the scope of risks to be covered, as set out in Box 6 is unduly large.

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

ESMA considers qualitative and quantitative requirements to calculate the amount of additional own funds or coverage of professional indemnity.

In regards to the quantitative requirements ESMA consults on two options.

Under Option 1 the additional own funds requirement for liability risk is equal to 0.01% of the value of the portfolios of AIF managed by the AIFM. The competent authority of the home Member State of the AIFM may authorize the AIFM to lower the percentage to 0.008%, provided that the AIFM can demonstrate -based on its historical loss data and a minimum historical observation period of five years- that liability risk is adequately captured. Conversely, the competent authority may rise the additional own funds requirements if they are not sufficient to capture liability risk arising from professional negligence.

Under Option 2 the additional own funds requirement for liability risk is equal to 0.0015% of the value of the portfolios of AIF managed by the AIFM plus 2% of the relevant income. The competent authority of the AIFM home Member State may authorize the AIFM to lower the percentage in relation to relevant income to 1% under the same conditions as in Option 1. As in the other option the competent authority may rise the additional own funds requirements if they are not sufficient to capture liability risk arising from professional negligence.

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

We do not believe this approach to be feasible and practical. Not only do performance fee structures vary widely in terms of calculation and timing across funds, in case of negative carried forward, the relevant income would have to be adjusted. It is our understanding that the latter is presently not foreseen.

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

We believe that commissions and fees payable in relation to collective portfolio management activities should not be included as this concept appears to correspond to the well-known "Management Fee. In our view the management fee should be clearly distinct from relevant income.

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

We have no comments to offer.

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

We are not aware of a specific internal example where the "Advanced Measurement Approach" would be used at this time. We would, however, welcome the possibility of being able to use the approach in the future.

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?

We would consider a five-year period to be appropriate.

C) Professional Indemnity Insurance

ESMA considers that as an alternative to the requirements regarding additional own funds, the AIFM may take out and maintain at all times professional indemnity insurance if it complies with certain requirements.

The coverage of the insurance per claim must be adequate for the individual AIFM liability risk. The minimum coverage of the insurance *for each claim* must at least equal the higher of the following amounts: (a) 0.75 % of the amount by which the value of the portfolios of the AIFM exceeds €250 million, up to a maximum of €20 million; (b) €2 million. The coverage of the insurance *for claims in aggregate per year* must be adequate for the individual AIFM liability risk. The minimum coverage of the insurance for all claims in aggregate per year must at least equal the maximum of the following amounts: (a) 1 % of the amount by which the value of the portfolios of the AIFM exceeds €250 million up to a maximum of €25 million; (b) €2.5 million; (c) the amount calculated according to Box 8.

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

No, we would consider the alternative approach unnecessarily complicated, in particular as it seems to require continual assessment for open ended structures.

IV.2. Possible Implementing Measures on General Principles
Due Diligence requirements

ESMA consults on the proposed due diligence requirements. Among other requirements AIFM are to establish written policies and procedures and implement effective arrangements for ensuring that investment decisions on behalf of the AIF are carried out in compliance with the objectives, investment strategy and, where applicable, risk limits of the AIF. The due diligence processes and procedures should be regularly reviewed and updated. Where applicable to the type of asset, the AIFM is among other points required to set out and update a business plan consistent with the duration of the AIF and market conditions.

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

We propose the term 'investment plan' instead. This is because the 'business plan' usually refers to target assets and revenues. We would welcome further clarity on the level of detail required and how such a requirement is to work in practice.

Inducements

UBS has significant concerns in regards to ESMA's proposals on inducements. We note that fees for marketing services will be governed by ESMA's advice. While we agree that these rules should apply to direct marketing by the AIFM, we would be very concerned if they would apply to "indirect marketing" for the following reasons:

First, the payment of distribution fees to remunerate the service of investment advice or distribution activities in general is not by nature "designed to enhance the quality of the collective portfolio management". Such payments are mostly extraneous to collective portfolio management. We would argue that they should be considered as a necessary cost instead.

Second, it is in our view disproportionate to seek to restrict the payment/receipt of inducements as the Directive is aimed at AIFs marketed to professional investors. It should be sufficient to rely upon the disclosure requirement in Para. 1 (b) (i).

Third, we would emphasize our view that it is not necessary to consider third-party distribution payments as inducements in the sense of Para. 1 (b) in order to ensure investor protection. Fees and commissions received by intermediaries as remuneration for the distribution service are already subject to the conditions of Art. 26 (1) (b) of the MiFID Level 2 Directive and to disclosure to investors at the point of sale.

Fair treatment by an AIFM

ESMA consults on two options in regards to the meaning of fair treatment by an AIFM. Under *Option 1* fair treatment by an AIFM *requires* that no investor may obtain a preferential treatment that has an overall material disadvantage to other investors. Under

Option 2 fair treatment by an AIFM *includes* that no investor may obtain a preferential treatment that has an overall material disadvantage to other investors.

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

We have split views on option 1 and 2. While we tend to agree with Option 1 as it gives a clear definition, we believe that further guidance would be required. Option 2 is vague due to the use of "includes" and would be best complemented by a complete list of fair treatment obligations.

IV.3. Possible Implementing Measures on Conflicts of Interest

IV.4 Possible implementing measures on Risk Management

ESMA considers a permanent risk management function to achieve a robust risk management framework and how the elements of the risk management provisions of UCITS implementing Directive can be applied to the AIFMD.

Functional and Hierarchical Separation of the Risk Management Function

According to ESMA the risk management function of an AIFM is considered functionally and hierarchically separate from the operating units, including the portfolio management function, where certain conditions are met. The separation of the functions is to be reviewed by the competent authorities of the home MS of the AIFM in line with the principle of proportionality sand in the understanding that the AIFM shall in any event be able to demonstrate that specific safeguards against conflicts of interest allow for the independent performance of risk management activities.

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?

We agree with ESMA's proposal and see no need for further safe guards. We do not see any particular difficulties in 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?

We do not believe any material issues would be faced by AIFs meeting this proposal and have no recommendations in relation to additional proportionality criteria. We already have an independent risk management function in our organisation.

IV.5 Possible implementing measures on Liquidity Management

According to ESMA a "special arrangement" is one type of tool or arrangement for managing liquidity. It is defined as an arrangement that arises as a direct consequence of the illiquid nature of the assets of an AIF which impact the specific redemption rights of investors in a class of units or shares of the AIF and which is a bespoke or separate arrangement from the general redemption rights of investors.

ESMA proposes this definition to include 'side pockets' and other mechanisms where certain assets of the AIF are subject to similar arrangements between the AIF and its investors. The suspension of an AIF is not considered a special arrangement. Other 'arrangements' such as gates are considered as special arrangements where they achieve similar outcomes to those achieved by side pockets.

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?

Yes, we agree that special arrangements should be considered only in exceptional circumstances where the liquidity management process has failed.

Liquidity management polices and procedures

According to ESMA AIFMs shall, for each AIF that they manage that is not an unleveraged closed-ended AIF, adopt appropriate liquidity management policies and procedures

enabling them to monitor the liquidity risk of each AIF and comply with their underlying obligations to investors, counterparties, creditors and other parties. Among others AIFMs are required to demonstrate to the competent authorities of its home Member State that appropriate and effective liquidity management policies and procedures are in place and that they have put in to effect tools and arrangements necessary to manage the liquidity risk of each AIF under its management. AIFMs are to identify the types of circumstances where tools and arrangements will be used in both normal and exceptional circumstances, taking into account the fair treatment of all AIF investors, in relation to each AIF under management. AIFMs may only use such tools and arrangements in these circumstances and if appropriate disclosures have been made.

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

While we support the principles based approach, we have concerns in regards to the disclosure. Without a clear definition of what is to be disclosed through which measurement technique, investors could be misguided by the information and are likely to draw the wrong conclusions when comparing AIFs.

Alignment of investment strategy, liquidity profile and redemption policy

ESMA consults on the circumstances under which the investment strategy, liquidity profile and redemption policy for each AIF managed by an AIFM can be considered to be consistent. The advice sets out the principle that investors should be able to redeem their investments in accordance with the AIF policy, which should cover redemptions in both normal and exceptional circumstances.

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

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

While we agree with ESMAs proposed advice in principle, we would like to emphasize that for certain type of funds such as real estate gaining an understanding of the liquidity profile and how it matches with the profile of investors is a challenging undertaking.

IV.6 Possible Implementing Measures on Investment in Securitized Positions

IV.7 Possible implementing measures on organizational requirements

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

Yes, a general complaints handling and whistle blowing system should be implemented.

IV.8 Possible implementing measures on Valuation

IV.9 Possible implementing measures on delegation

In line with MiFID ESMA sets out the general principles an AIFM should comply with when delegating tasks to third parties and consults on two options for the AIFM being able to justify its delegation structure on objective reasons.

According to Option 1 which is based on the UCITS approach this condition is fulfilled if the AIFM is able to demonstrate that the delegation is for the purpose of a more efficient conduct of the AIFM's management of the AIF. Option 2 provides a non-exhaustive list of objective reasons for delegating tasks instead of providing a high-level principle. Examples of objective reasons are cost savings, expertise of the delegate in administration or in specific markets / investments or access of the delegate to global trading capabilities.

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

We prefer option 2, the non-exhaustive list for delegating tasks, as it has the greater flexibility and does not just rely on having to demonstrate that delegation is for the purpose of a more "efficient" AIF management.

PART 2 – DEPOSITARIES

V. Depositaries

As a general comment we would note that the AIFM depositary's liability regime is a central issue of the AIFM Directive and has caused intense debate in the depositary and custodian industry. In that context, we recognize that the implementing measures as proposed by ESMA aim to strike a balance between ensuring a high degree of investor protection, while refraining from requiring the depositary to act as a full-scale insurer against any and all risks. While the implementing measures seem workable, the underlying concept of the depositary function and associated liability in the Directive, however, seem to based on the assumption that all fund assets are normally, as a general principle, safe-kept at the depositary, and that depositaries choose to outsource certain tasks to sub-custodians or other agents at their own discretion and for their own convenience. We would like to emphasize that this assumption does not reflect the reality that depositaries do not have such discretion. No depositary can perform its safekeeping function without engaging sub-custodians and/or third party agents, at least as soon as cross-border investments are involved, and as soon as asset types are involved that exist in book-entry or immobilized form only, which is predominantly the case today.

V.1 Appointment of a Depositary

V.2 Duties of the Depositary

V.3 Depositary functions

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?

Conceptually, the role of the depositary is to handle the "fund side" of the business, i.e. to safekeep the assets of the fund. The "investor side" of the business, i.e. handling subscriptions and redemptions and maintaining the shareholder/unit register, is the role of the Distributor and the Transfer Agent ("TA"). Becoming directly involved with handling investor payments would be an extension of the role of the depositary. This is not market practice today.

If subscription / redemption accounts would have to be opened at the depositary, this would effectively mean that each distributor would remit subscription payments to the depositary, while the latter would pass on the funds immediately to the TA. Since the TA can only issue shares once the subscription money is in the fund's account, there is a risk of delays in the issuance of shares. The same is true for redemptions, in the opposite sense.

For this reason, it is in our view only feasible and reasonable to comply with such a requirement, if the depositary would also be responsible for issuing the unit certificates. Where this is not the case, the TA and depositary functions would have to be synchronized, which would cause additional burden.

Specifically for hedge funds we would emphasize the fact that such a requirement does not conform to the current market practice. For instance, in our single manager business all subscription cash and the transfer agency are managed by an independent administrator. The trading assets of the fund, including cash, are held at multiple prime brokers. The delegation to multiple prime brokers is to reduce risk, and there is also an element of market expertise and access. There is no relationship between the administrator and the prime brokers. Fund of funds are different in that both accounts are held at the administrator. It is furthermore important to note that where managers have different funds with multiple prime brokers, they may only have one pooled subscription / redemption account covering a number of AIF. It would be operationally complex if managers would have to open subscription / redemptions accounts at each individual depositary / prime broker.

Overall we believe that it would be onerous to make the required changes to current practices and procedures with little perceived benefit to investors. It could potentially also lead to an increase in operational and credit risk. In our view the same effect could be achieved by requiring the depositary to ensure that appropriate checks and controls are in place at the TA / independent administrator and that recordkeeping and reconciliation procedures work effectively.

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

This is a difficult answer to provide as the reconciliation frequency may vary from fund to fund and is dependent on different factors such as frequency of the cash flows of the fund

and the service level agreement with the depositary or fund administrator in regards to the NAV calculation. For example, the reconciliation of real estate funds in Luxembourg is done on a day to day basis for bank accounts held with the custodian, with transactions executed via third parties during the NAV calculation on a quarterly basis. In Germany and other jurisdictions, it is common practice for real estate funds to reconcile on every exchange date. For AIFs which are hedge funds most reconciliation are performed on a daily basis and no distinction is made depending on the type of assets.

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

We do not believe that there are any particular problems associated with Article 18 of MiFID, which requires that the Fund Manager must deposit client funds received as soon as possible in an authorized bank, inside or outside of the EU. It is our understanding that the depositary is not necessarily required to be classified as a credit institution however.

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

We do not see any particular difficulty as long as Option 2 of Box 76 is implemented. Please refer to our comments in Q29. Sufficient reporting is usually received from prime brokers to enable timely cash reconciliation.

We refer to our comments in Q25 specific to hedge funds. All fund operating accounts are held at the prime broker for single manager funds. Subscription cash is held separately from the trading cash at the prime broker. Fund of funds cash is currently held at the administrator and not with a prime broker.

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

Under option 1, the depositary would be considered as a central hub where all information related to the AIFs cash flows is centralised, recorded and reconciled in order to ensure that an effective and proper monitoring of all cash flows. In particular it has to ensure that cash belonging to AIFs is booked in an account opened at the depositary. Where cash accounts are opened at a third party entity it includes (i) a requirement to mirror the transactions of those cash accounts into a position keeping system with periodic reconciliation and (ii)

ensuring that the AIFM has taken appropriate measures to send instructions simultaneously to the third party entity and the depositary.

Under option 2, the depositary's obligations would consist in verifying that the AIFM has put procedures in place to appropriately monitor the AIFs cash flows and that they are effectively implemented and to periodically review the adequacy of the procedures. The depositary would be required to look into the reconciliation procedure to satisfy itself that they are suitable for the AIF and performed at an appropriate interval taking into account the nature, scale and complexity of the funds.

In our view Option 1 will be very difficult and costly to achieve in practice. Option 1 also has the potential to create significant additional risks in the settlement system. The ability of a depositary to intervene where it considers that a cash flow is inappropriate could lead to AIF clients potentially unhedged as well as leading to downstream settlement failures. As such it could give rise to increased systemic risks. Furthermore Option 1 may be inconsistent with "delivery versus payment" (DVP) as a settlement method which is a very significant issue since DVP was developed as a settlement method to remove the risk of sending payment for securities to a counterparty without certainty that the purchased securities would be delivered.

We therefore prefer option 2. Option 2 entails some uncertainty regarding the meaning of the terms, "timely", "periodically"; "at proper intervals", however, we believe that this has the benefit of leaving room for market standards to evolve over time that could be used as benchmarks.

Q30: What would be the estimated costs related to the implementation of option 1 or option 2 of Box 76?

We are unable to provide a specific cost estimate, but believe that option 1 would be much more expensive to implement that option 2. This is because the cost of setting up and running a fully fledged operation on an ongoing basis, in contrast to the cost of periodically auditing an operation, is likely to be significantly higher. We also expect the costs related to any interference with recognized settlement systems in particular DVP to be significant.

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

We have not produced a cost estimate. The mirroring approach causes an additional effort to reconcile the mirror account balances against the "live" account balances, and to research the causes of any discrepancies between the two. We believe the costs to be substantial, both for implementation as well as for subsequent operation. Overall we would question the value of such a mirroring approach. In our view its impact on protecting the fund assets is limited and does not justify the additional costs to be incurred.

Definition of financial instruments to be held in custody

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

ESMA's advice aims to provide a clear definition of the financial instruments to be held in custody. According to ESMA, the suggested definition is designed to capture all financial instruments the depositary is in a position to control and if need be retrieved. As such, ESMA consults on two drafting options, both of which explicitly exclude all securities that are directly registered with the issuer or its agent (e.g. registrar or TA) in the name of the AIF, all assets that take the form of a financial contract as well as investments in privately held companies or real estate assets.

Option 1 contemplates a definition by which all financial instruments registered or held in account directly or indirectly in the name of the depositary through a subsidiary or sub-custodian would be considered as instruments to be held in custody. Where the depositary is acting on behalf of the AIF as the ultimate owner of the financial instruments, the depositary is only required to perform record keeping duties.

Option 2 refers to the use of settlement systems to define what financial instruments would be held in custody. Under this approach only financial instruments with respect to which the depositary may itself or through its sub-custodian instruct the transfer of title by means of a book-entry on a register maintained by a settlement system would be subject to custody.

We would prefer option 2 as it reduces the scope of instruments which fall under the definition of "held in custody", thereby decreasing the risk that the depositary has to make

restitution for instruments lost. For example, it is our understanding that Option 2 would exclude offshore funds (e.g. Cayman funds) even in case of a nominee registration. Current practice would consider such financial instruments as under custody if registered in a nominee name (and not in the name of the AIF). It is, however, not clear to us what the practical consequences of the reduced scope would be in regards to the potential need to change our systems and reporting to clients.

We would welcome clarification that where a right of use has been exercised, such assets are no longer in custody.

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?

In practice, all types of fungible securities and similar financial instruments will be held either through a global custodian, with sub custodian agents, or in a central depositary, whether they are physically deliverable or dematerialized. In addition, fund shares registered directly with the transfer agent in the name of the depositary or a nominee are considered financial instruments held in custody.

According to ESMA, all assets that take either the form of a "financial contract" or investments in privately held companies and real estate assets, are excluded. We agree with these exclusions and understand the first to mean mostly OTC derivatives. We also agree that assets held by the AIF directly with the issuer or its registrar in the AIF's own name should not be considered as assets "held in custody" by the depositary.

Treatment of collateral

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

ESMA suggests excluding from the scope of the depositary's custody duties all financial collateral arrangements where there is a title transfer and has put forward three options regarding the treatment of security financial collateral arrangements: Option 1 excludes only financial instruments *subject to a title transfer collateral arrangement*. Option 2 excludes financial instruments *subject to a title transfer collateral arrangement* and financial instruments *subject to a security financial collateral arrangement where the arrangements*

includes the transfer of the instruments out of the depositary's books. Option 3 excludes *all financial instruments subject to a collateral arrangement in whatever form*.

In our view the description of Options 1 and 3 are clear, however less so in case of Option 2 as there may be uncertainty as to different concepts of possession and control. For UBS Option 3 is the preferred option.

In our view it should be apparent from entries in books and records as to the nature of a particular collateral arrangement and whether it is a title transfer arrangement or a security interest arrangement. Industry standard legal documents governing such arrangements are also generally clear on these points.

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

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

The parties involved in such "other than custody" tasks are third parties with whom the depositary does not have an account relationship. The key element is the requirement on the AIFM to ensure that those third parties provide to the depositary (audited) account statements or similar documents evidencing the AIF's ownership of the assets in question. The depositary's duty should however not include an in-depth verification that ownership is legally perfected.

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

Under (i) where the assets are registered in the name of the AIF directly, the depositary does not have any control over the assets and cannot prevent the AIF from accessing them. As such the depositary has no possibility to prevent any transaction ex ante.

Under (ii) where the assets are registered in the name of the depositary on behalf of the AIF the depositary has full control and the AIF in theory should not have any access to the assets under normal circumstances. However, practical experience suggests that this

approach is not watertight if the goal is to ensure that the AIF does not have access without the depositary's consent.

Under (iii) where the assets are registered in the name of the depositary on behalf of a group of unidentified clients, the depositary has full control over the AIF assets. The AIF or AIFM have no access to the assets since the issuer or registrar has no evidence that such party is indeed the ultimate asset owner and entitled to give instructions.

We would like to draw ESMA's attention to the fact that specifically in the case of real estate funds, registering the assets in the name of the depositary is to be regarded as highly problematic as it is likely to trigger the payment of transfer taxes. This is because fund assets are registered in the land registry in the fund name and properties would have to be re-registered. Changing the title to the depositary would be an expensive as well as time-consuming exercise requiring significant operational changes. The holding of title deeds could also prove to be difficult. In the UK, for example, it is current practice that solicitors hold deeds in their safe. Introducing a third party depositary is unlikely to provide additional investor protection or benefit.

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

In the UK there is a regulatory requirement for UK domiciled prime brokers to provide daily reports to prime brokerage clients.

Ownership verification and record keeping

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

To achieve a sufficient level of comfort that the AIF is indeed the owner of the assets, ESMA suggest that the depositary should make sure it receives the necessary information. Under Option 1 the depositary should (i) ensure that there are procedures in place so that assets registered cannot be assigned, transferred, exchanged or delivered without the depositary or its delegate having been informed of such transaction or (ii) have access to documentary evidence of each transaction from the relevant third party on a timely basis. Under Option 2 the depositary should mirror all transactions in a position keeping record.

UBS prefers Option 1 for similar reasons as set out in our response to Q31. Although we have not quantified the cost of either option, we believe the cost of a mirroring mechanism as set out in Option 2, to be significantly higher, both for implementation as well as for subsequent operation, without an added value that would justify the incremental expense.

We would emphasize that prime Brokers already provide daily reporting to clients of their positions. Therefore we do not think that additional mirroring will add much or anything and will add increased costs to the AIF.

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

We support ESMA's view set out in Explanatory Note 38: The depositary should verify the quantity and location of the underlying assets. This verification should be based on evidence prepared by an independent source (meaning a party not affiliated with the AIF or the AIFM) and the evidence should raise no obvious doubt that the assets are indeed in the ownership of the AIF or the AIFM on behalf of the AIF.

We believe, however, that the depositary's obligation should not include the need for an in-depth verification that ownership is legally perfected. In relation to assets held through Special Purpose Vehicles (SPVs), the question arises whether the depositary has to look through a chain of SPVs at least until there is a SPV which is not a controlled subsidiary.

Specifically in relation to real estate funds, we would like to stress the fact that it is common for the depositary bank to obtain annual extracts from the land registers to ensure ownership. In our view evidence of title should be sufficient to verify the ownership for this particular type of funds. In relation to hedge funds we would emphasize that the prime broker currently holds the fund trading assets. These are independently verified by external auditors.

3. Oversight duties

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

We think that additional oversight will result in increased costs which will be ultimately borne by investors without sufficient reduction in risks. We note that in those jurisdictions where investors have the choice to choose to separately appoint a custodian/depositary they rarely do so.

Overall, we see no substantial need for additional clarification. The role of the depositary is clearly defined in that all parties which the depositary has to oversee, must actively cooperate and enable the depositary to perform its duty. The advice rightly makes it clear that the depositary duties should not be extended to monitoring the investor side of the business, for instance compliance with sales restrictions and similar Know-Your-Customer issues. This is the duty of the distributor and the transfer agent.

In our view the scope of the depositary's oversight duties would be best organized in line with three guiding principles: First, ex post controls only, as ex ante controls are not feasible operationally. Second, periodic controls, as opposed to continuous controls, which in our opinion are not economically feasible. Third, limitation to fund-side oversight duties, specifically no extension to include investor-side oversight duties.

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

When the depositary is designated to issue shares of the AIF, the same institution acts as transfer agent ("TA") and depositary. In practice there are likely to be some tasks housed with the TA which the depositary is mandated to control and which could give rise to potential conflicts of interest. An example is the requirement to reconcile the subscription orders with the subscription payments received and with the fund shares issued. We would consider this to be the core business of TAs and appropriate policies and procedures should be in place to manage potential conflicts of interest.

In our view, an independent control would require a strict separation from the depositary function issuing the shares. Ideally these functions would be performed by separate legal entities and as minimum, separate departments within the depositary.

Duties related to subscriptions / redemptions

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?

Typically reconciling subscription orders with subscription proceeds is not a depositary task today, at least not on an individual transaction level. That task is considered to be "client side" business and therefore falling into the function and responsibilities of the transfer agent. If we see this reconciliation as a means to ensure that the aggregate number of issued fund shares are at all times backed by corresponding assets in the fund, then the involvement of the depositary as a second level controller can be justified. As a principle, however, we would stress our view that the depositary should not be involved with the investor-facing side of the funds business.

There are, however, differences depending on the jurisdiction as well as type of assets managed by the AIF. Taking our real estate funds as an example, we would emphasize the fact that in Luxembourg requirements of the subscriptions proceeds are received at the depositary, who then calculates the units to be issued based on the latest available NAV. Hence the reconciliation is performed by the depositary from the start. This equally applies for redemptions. In contrast real estate funds in the UK currently have no depositary involvement with respect to the reconciliation of subscription orders with subscription proceeds. In Germany reconciliation by the depositary is considered standard practice.

In the case of hedge funds, the Depositary (PB) has no involvement in the reconciliation of subscription orders and proceeds.

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?

Explanatory note 56 describes this problem, and we share ESMA's view that the requirement should not be extended. We also agree with the reasons given by ESMA: If fund units are sold in the secondary market, or transferred between investors without the involvement of the transfer agent ("TA"), neither the TA (to which the fund typically outsources the KYC duty) nor the depositary are in a position to control whether all fund investors comply with potential funds selling restrictions. This is one of the main reasons why most TAs oppose secondary market trading of funds that were issued with a primary market environment in mind.

We believe that the only workable solution to this issue would be for the "Know your Customer" requirement to be rendered by the institution having the direct (bank) relationship with the investor and which as such "owns" the direct account relationship with the ultimate investor. Depending on the intermediary chain, this may be the TA or a fund-appointed Distributor, or a sub-Distributor further down the chain.

Duties related to the carrying out the AIFM instructions

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

We consider that monitoring and compliance with investment restrictions and leverage limits should be the responsibility of the AIFM rather than the depositary. The investors choose the AIFMs to manage their assets not the depositary and we note that the AIFM will be a regulated entity. Given that many funds have sophisticated investment strategies with sophisticated sets of investment restrictions/leverage arrangements, the requirement that the depositary monitor these would require the depositary incurring significant cost in acquiring the systems and staff who would be able to understand and then monitor such restrictions/arrangements.

We also think it is important to avoid situations where the depositary could be put in the position of directing the investment activity of the AIF – this should be the responsibility of the AIFM.

Duties related to the timely settlement of transactions

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

ESMA consults on two options in regards to the duties related to the timely settlement of transactions. While Option 1 foresees no additional requirement, Option 2 requires the depositary to set up a procedure to detect any situation where the consideration is not remitted to the AIF within the usual time limits, notify the AIFM and where the situation has not been remedied, request the restitution of the financial instruments from the counterparty where possible.

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

We have no clear preference in regards to the two options discussed. From an operational perspective, Option 2 provides a clear description of the depositary's responsibilities, not only in regards to regulated markets but also non-standardized business processes in unregulated markets. From a legal point of view, we would have a preference for Option 1.

We would like to draw ESMA's attention to the fact that the depositary's oversight duties related to the timely settlement of transactions currently differ depending on the jurisdiction as well as type of assets managed by the AIF. In Luxembourg and Germany, for example, the current duties of a depositary correspond to Option 2, whereby the depositary informs the management company where the usual time limit is not adhered to. The usual time limits are usually those defined in the PPM. The management company will then decide how to proceed. In contrast in the UK the current duties of a depositary correspond to Option 1.

Section 2 - Due Diligence Duties

According to the AIFMD the depositary has to perform due diligence whenever it delegates any of its safekeeping functions whatever the type of assets. ESMA believes that the delegation of record-keeping task would, in most cases, mainly concern administrative tasks and as a result the depositary would only be required to implement an appropriate and documented procedure to ensure the delegate has the structure and expertise to perform the delegated tasks. With regards to the delegation of custody, ESMA puts forward some

guiding principles rather than a list of tasks as the latter would entail a box-ticking approach and would not guarantee a sufficient level of protection. The principles such as the sub-custodian's financial strength and ability to provide reasonable care to the financial instruments help the depositary assess whether the risk of delegation is acceptable.

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

This is really a question of local law/practice in the relevant markets. In markets which do not recognize the effects of segregating client and proprietary assets, in general, insolvency law does protect at least all assets (client and proprietary) of the depositary held with a sub-custodian, in case of the sub-custodian's insolvency. The depositary's books and records should be clear as to the ownership of those assets which were being held with the sub-custodian and whether they were proprietary or client assets.

On a broader note we would argue that it does not seem to us to be appropriate that the depositary is subject to a higher standard in relation to a particular market compared to the sub-custodian operating in that market. The result would likely be that depositaries would be reluctant to agree to hold assets for clients in those markets via sub-custodians thereby reducing investor choice.

We are not in a position to provide a list of critical countries, or an estimated percentage of custody assets that may be affected, in the time available.

V.4 The depositary's liability regime

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

While we are unable to provide a concrete figure for a cost estimate, we would see two clear consequences of the proposed liability regime particularly where the fraud, negligence or insolvency of a sub-custodian is deemed to be an "internal" event.

First, we would expect the liability of a depositary to increase. How this translates into additional cost is difficult to quantify. We anticipate that this liability would lead to significantly increased capital costs for depositaries which would ultimately be passed on to investors via higher fees. It may also prove uneconomic for many depositaries to continue to act in this role. We also think there are potential systemic risks posed by the proposed liability regime. Furthermore it is very unlikely that any form of insurance will be available to cover depositaries for their exposure.

As an example of the cost implications of the proposed liability regime we have considered the following example: We understand that a custodian for a developed Western European country such as Germany currently may charge 0.005%/per year on positions of around EUR 1bn, or EUR 50,000 per year. If we assume that a depositary accepts the liability for EUR 1bn of a client's German assets and those assets were "lost", then on the current rates charged by custodians, it would take 20,000 years for the depositary to earn sufficient revenues from an equivalent EUR 1bn position to recoup the liability it has incurred.

In practice, depositaries occasionally absorb losses for which they are not strictly liable, in the interest of ensuring client retention. The proposed regime will increase the liability situations where the absorption of a loss by the depositary is no longer a question of goodwill and commercial judgment, but simply unavoidable. As a principle, prudent business practice would suggest that a depositary should organize itself in a way so that most of its liabilities towards its clients are rolled over correspondingly to its sub custodians, or other service providers.

Second, as a means to reduce the depositary's exposure to the extent possible, its cost and effort for conducting sub custodian due diligence and business contingency measures, is likely to increase.

In responding to this question we have assumed that the ESMA advice reflects how a prudent depositary should act without being the ultimate safeguard in any event.

Definition of loss

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

The circumstances leading to loss events are already summarized in the listing that precedes Box 90. Events categorized under Acts of God or Acts of State are mentioned in explanatory note 22 following Box 91. A secured party enforcing its rights over an AIF's assets should not be considered to be a "loss".

Overall we find it challenging to provide a proper typology of events.

Q49: 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?

We do not see any difficulty with this suggestion. If local legislation overrides the most obvious safety measure a depositary can take to protect its client assets, that seems to be an external event par excellence.

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

We consider that it is very important that the insolvency of a non-affiliate sub-custodian be defined as an "external" event. Otherwise significant contingent liabilities could be created for depositaries which will result in higher capital costs and which will not likely be insurable.

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

We identified two events or "topical baskets", not addressed in the paper, which could be either internal, external, or a mixture of both, and which create uncertainty. The first type of event relates to breakdowns, temporary outages, service disruptions, hacker attacks and similar events that occur in connection with the use of IT and telecommunication infrastructures. In general, these are partly internally controlled structures, but linked to outsourced activities, or external service providers. It is not always clear how far the scope of internal responsibility extends. Second, strike of a workforce: the occurrence of a strike could be beyond the control of a depositary, but it could just as well be a direct or indirect result of actions taken, or not taken by a depositary.

In addition, practical experience shows that operational losses often cannot be pinpointed to one single cause, but are the result of an unfortunate combination, or accumulation of several failures or errors along a process chain. The individual elements could be a mix between internal and external factors. The parties would then be likely to enter into lengthy negotiations to steer into the direction most favorable to them. We however have no suggestion for a better definition of "external event beyond reasonable control".

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

A depositary will almost always have no other choice than to engage sub custodians or other types of subcontractors. In order to provide efficient sub-custodian services, depositaries organize their network through affiliates and third-party sub-custodians based on criteria like market presence, legal, technical and economic grounds. In practice, when the sub-custodians are not affiliates of the depositary, it will be very difficult that sub-custodians would agree to have liability passed onto them, and if they considered it, they would require compensation and safeguards. Still, we believe such a risk transfer would be very difficult as it would not be cost efficient for a sub-custodian, as the risk-benefits balance would be disadvantageous for the sub-custodian.

Under the AIFMD we note that a depositary cannot pass its liability to a third party unless it has "ensured" a number of conditions (Art 21, para 10(d)). Some of these may be difficult to fulfill. For example, that the depositary needs to "ensure" that the sub-custodian segregates client assets from proprietary assets. The depositary can only request that the sub-custodian does so and use due diligence methods to check this. Unless the sub-custodian is in the same group as the depositary, the best a depositary can ever do is to take "commercially reasonable steps to ensure".

As such we would see two areas where the relationship of a sub custodian to the depositary (i.e. inside or outside the group) makes a difference: First, experience shows that a depositary (same for a Global Custodian) is more readily prepared to accept liability for a sub custodian, if that sub custodian is a subsidiary within the same group. Second, it would be in the case of absorbing an operational loss, which may then be absorbed fully or partially by an external party, respectively by shifting money from "the left to the right pocket" within the same group.

In addition, we have the following comments to make on objective reasons for the depositary to contract a discharge. ESMA proposes two options. Under Option 1, a depositary would be allowed to contractually discharge itself of its liability where it had no other option but to delegate its custody duties to a third party due to legal requirements or if it has agreed with the AIF/AIFM via a written agreement that it is in the best interest of the AIF and its investors to delegate such duties. The "best interest" of the latter would be achieved if there is no disadvantage for them from the liability transfer. Under Option 2, a depositary and AIF/ AIFM have explicitly agreed via a written contract to a discharge of liability. Our preference is Option 2, as it will be difficult in practice to show that delegation of custody duties to a third party was indeed in the "best interest". If liability issues arise later on, the depositary would be an easy target as it might be difficult to prove the contrary.

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

We believe that the proposed framework is workable.

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

The frameworks seems broad yet clear enough to cover a wide range of AIFs. AIFs are by nature a business driven by non-standardized products and individual solutions. We also refer to our comments in Q25. In our view the Implementing measures should not aim to be tailored to each and every hypothetical type of AIF. The resulting complexity would create more uncertainty for a majority of depositaries, AIFs and AIFMs, than the benefits it would create for those AIFs that would actually need very specific tailoring. We would suggest a review of the implementing measures at a later time with a view to make further amendments as, if and when practical experience shows a specific need.

Part 3 – Transparency requirements and leverage

VI Possible implementing measures on methods for calculating the leverage on an AIF and the methods for calculating the exposure of an AIF

Methods of Increasing the Exposure of an AIF

ESMA consults on the methods that could be used to increase the exposure of an AIF and provides an indicative list. Methods include unsecured cash borrowings, secured cash borrowings, convertible borrowings, interest rate swaps, Contracts for Differences, futures contracts, Total Return Swaps, forward agreements, options, repurchase agreements, reverse repurchase agreements, securities lending arrangements as well as securities borrowing arrangements.

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?

In our view there are no additional methods to be included.

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 specificity be included within the Advanced Method to assist in its application?

We do not believe that any additional specificity should be included within the Advanced Method.

Q57: Is further clarification needed in relation to the treatment of contingent liabilities

We do not believe that further clarification is needed in relation to the treatment of contingent liabilities.

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 provides a return at the risk free rate and are held in the base currency of the AIF should be excluded?

No, Cash and cash-equivalent positions are an asset of the fund and should not be excluded.

Exposures involving third party legal structures

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

Under Option 1 the calculation of leverage includes any exposure which is contained within financial and/or legal structures involving third parties to the extent that *entities involved within those structures have recourse to the AIF via cross-collateralisation or guarantees, including guarantees*, where there is an expectation that the AIF will contribute to the underlying structure even through there is no legally enforceable obligation.

Under Option 2 the calculation includes any exposure which is contained within financial and/or legal structures involving third parties to the extent that *entities involved within those structures are non-listed companies or issuers controlled by the AIFM* within the scope of Article 26 and have *recourse to the AIF via cross-collateralisation or guarantees, including guarantees,* where there is an expectation that the AIF will contribute to the underlying structure even though there is no legally enforceable obligation.

Under Option 3, the calculation includes 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. Any exposure which is contained within financial and/or legal structures involving third parties to the extent that the AIF has provided guarantees for any shortfall in the value of the property relating to the underlying shares or

units have been secured or where a loan has been secured on property relating to the underlying shares or units outside of a portfolio company structure by way of cross-collateralisation are to be included in the calculation.

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

We would have a preference for the second option given the type of structures that we manage internally.

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?

We do not agree. This would be difficult, onerous and would capture portfolio company effects.

VII. Possible Implementing Measures on Limits to Leverage or Other Restrictions on the Management of AIF

Q61: Do you agree with ESMA's advice on the circumstances and criteria to guide competent authorities in undertaking an assessment of the extent to which they should impose limits to the leverage that an AIFMD 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

We appreciate ESMA's effort to give advice on this difficult, challenging and important issue. It is our view that imposing limits to leverage is not an adequate tool for managing the systemic risk of financial markets for the following reasons.

First, the measurement of leverage of an AIF requires a differentiated approach. Each investment strategy has a specific investment profile. As such the leverage of each strategy differs considerably. High leverage per se does not necessarily imply a higher risk profile of a specific AIF.

Second, leverage typically is a direct function of the volatility in the markets. If leverage is high across investment strategies, it is often only reflective of low volatilities (risks) of financial markets. As such, it would not be correct to draw the conclusion that higher cross industry leverage implies a higher systemic risk. Volatility is the basis for calculating margins for exchange traded products, including futures. If the volatility of a certain market increases, then the margin requirement is increased by the exchanges and prime brokers. Only if a high leverage is used without proper collateralization (e.g. margins), then financial markets are likely to experience high systemic risks.

Third, risk taking is a required and key element for a robust functioning of financial market. The potential power of a competent authority to restrict leverage implies that the regulator is best suited to decide on the appropriate level of leverage. In this context it is our view that this proposal goes way beyond the regulation of individual funds and is looking to control risk across an industry. Furthermore it seems to give competent authorities a free hand in stepping in and creating restrictions.

A more reasonable and practical step would be to ensure that each AIF leverage is clearly assessed and disclosed to investors.

Q62: What additional factors should be taken into account in determining the timing of measures to limit leverage or other restrictions on the management of AIF before these are employed by a competent authority.

Taking additional factors into account will not solve the problem as markets behave in a stochastic way, i.e. one will not really know whether a factor helping today will do so tomorrow / what the relevant factors tomorrow will be. And this is even more true under stress than in normal situations.

VIII. Transparency Requirements

VIII. Possible implementing measures on annual reporting
VIII.1 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?

Format and content of the financial statements should be practicable and in line with local GAAP.

Remuneration Disclosure

The Directive stipulates that the total amount of remuneration for the financial year, split into fixed and variable components paid by the AIFM, should be disclosed as with the number of beneficiaries. According to ESMA the AIFM should have the ability to choose to present total remuneration either at the level of the AIFM, or the AIF, provided adequate disclosure is made. Where information is presented at the level of the AIFM further perspective is to be provided by disclosing an allocation or breakdown of the total remuneration as it relates to the relevant AIF. This could be achieved through disclosure of the following: (i) total AIFM remuneration data split in to fixed and variable components; (ii) a statement that this data relates to the entire AIFM, and not to the AIF; (iii) the number of AIF and UCITS (if any) funds managed by the AIF; and (iv) the total AUM of such AIFs and UCITS with an overview of the remuneration policy and a reference to where the full remuneration policy of the AIFM is available at the request of investors.

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?

The approach as outlined raises a number of questions. It is, for example, not clear to us if "staff involved in the activities of the AIF" is meant to address portfolio managers**.** Overall we believe that proposed approach raises a potential issue depending on who the AIF is. For example, in case of our real estate funds in Luxembourg, we do not have any remuneration if it is the management company. This is for two reasons. First, the directors do not receive any remuneration and second, there is no staff in the management company as all tasks are outsourced to third parties. The management company, however, receives a management fee which is already disclosed in the FS.

The total as well as the split into fixed and variable remuneration of staff by AIF requires a cost allocation system across all products (funds and mandates) which is difficult to estimate.

VIII.2 Possible implementing measures on disclosures to investors

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?

In our view, disclosing new arrangements will not impose additional liability obligations. We are concerned, however, that disclosing the risk profile and especially risk limits, will markedly increase liability obligations.

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

Yes we agree, but have no comments in relation to what arrangements may not be captured.

Periodic Disclosure to Investors

ESMA consults on two options in regards to the risk profile of the AIF. AIFMs are to disclose the current risk profile of each AIF as part of their obligations relating to periodic disclosure to investors as required by the AIF rules or instruments of incorporation, prospectus and offering documents and, at a minimum, in the annual report of the AIF.

Under Option 1 AIFM shall ensure that periodic disclosures shall contain an assessment of the exposure of the AIF's portfolio to the most relevant risks to which the AIF is, or could be, exposed, including where risk limits set by the AIFM have been, or are likely to be, exceeded. Where these risk limits have been exceeded the disclosure should additionally include a description of the circumstances and, where applicable, the remedial measures taken.

Under Option 2 the periodic disclosure by AIFM contains (a) Identification of the most relevant risks to which the AIF is or could be exposed; (b) measures used by the AIFM to assess any sensitivity in the AIF portfolio to the most relevant risks to which the AIF is, or could be, exposed; and (c) the results of any relevant stress tests, or an indication as to whether the exposure is likely to increase, is stable or is decreasing and within, near to, or exceeding risk limits set by the AIFM. Where risk limits have been exceeded the disclosure

shall additionally include a description of the circumstances and, where applicable, the remedial measures taken.

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

We would favour option 2 as this requires us to identify risks, whereas option 1 requires exposure of risks to be reported. Confidentiality of positions is vital in the marketplace.

For Part II Funds we support quarterly or even monthly periodicity as we envisage making the risk profile part of the monthly Factsheet. Specifically for our German real estate funds we would have a preference for semi annual disclosure in order to comply with the standards of the BVI (German Fund and Asset Management Association).

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.

We do not believe that specific guidance is required.

VIII.3 Possible implementing measures on reporting to competent authorities

Format and Content of Reporting to Competent Authorities

ESMA sets out that AIFM shall report on a quarterly basis to the competent authorities of its home Member State information including

(a) the original and revised maximum leverage level (Gross Method of Calculating the Exposure of the AIF and either Commitment Method or, where applicable, Advanced Method of Calculating the Exposure of an AIF). The level of leverage is to be calculated in each case as the relevant exposure divided by the net asset value of the AIF;
(b) the markets of which it is a member or where it actively trades;
(c) the diversification of the AIF's portfolio including, but not limited to, its principal exposures and most important concentrations.

The information is to be provided no later than one month after the end of the relevant period. For each EU AIF it manages and for each of the AIF it markets in the Union the AIFM is to provide information to the competent authorities of its home Member State including

(i) a description of the risk management systems employed by the AIFM to manage market risk, liquidity risk, counterparty risk and other risks including operational risk;(ii) the current risk profile of the AIF, (iii) information on the main categories of assets in which the AIF invested including the corresponding short market value and long market value, the turnover and performance during the reporting period; and (iv) the results of periodic stress tests, under normal and exceptional circumstances.

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

The proposed frequency of disclosure would cause particular difficulties for our real-estate funds as most of the underlying real estate assets are valued only once a year. It is our view that the frequency of the disclosure should be related to the liquidity of a fund. As an example, a closed ended fund should not need to report quarterly. The frequency should be reduced to once a year in this case.

The reporting template in Annex V itself is much too complex for real estate funds, which do not invest in most of the listed instruments and generally put only a small part of their funds in assets other than real estate. The pro forma template should therefore be individualized for the different fund types.

We would also welcome clarity on a number of terms used such as expected return, volatility (we would also question the usefulness of including the latter), liquidity profile of underlying assets (what exactly is the definition of liquidity at the asset level and why is it useful beyond a current snapshot) as well as definition of turnover (should be the same as for UCITS).

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.

Initial costs are difficult to estimate as it involves costs for specific IT solutions. We estimate ongoing reporting costs covering all our Part II Funds to amount to about 2-3 FTE headcounts. For our real estate funds we would estimate that ongoing reporting costs covering will amount to about 0, 5 FTE headcount.

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?

Specifically for real estate funds the deadline is too short, as some funds only have the figures ready one month after the reporting period. We would propose 60 days instead. Referring to our comments in Q69 we would stress our view that the reporting template in Annex V itself is much too complex for real estate funds, which do not invest in most of the listed instruments and generally put only a small part of their funds in assets other than real estate. The pro forma template should therefore be individualized for the different fund types.

Use of Leverage on a 'Substantial Basis'

ESMA sets out that an AIFM employing leverage shall make an assessment for each EU AIF it manages and for each of the AIF it markets in the Union as to whether leverage is being employed on a substantial basis. The assessment of whether leverage is employed on a substantial basis shall have regard to a number of non exhaustive considerations. AIFM shall monitor, on an ongoing basis, their use of leverage and, where there is a material change shall carry out a new assessment.

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?

In our view the advice is not and cannot be sufficient for a number of reasons. AIFMs cannot know (i) what the implications of its exposures (including leverage) are with regard to market risk, liquidity risk or counterparty risk to another credit institution, (ii) whether the techniques employed could contribute to the aggravation or downward spiral in financial market prices, and (iii) whether the degree of leverage could contribute to the build-up of systemic risk. It is not possible for any market participant to assess such implications as this would require to know all market participants' preferences, production technologies and the way they interact.