

J.P. Morgan Asset Management's comments on ESMA's draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive

This submission reflects the views of J.P. Morgan Asset Management ("JPMAM"), the investment management division of JPMorgan Chase & Co. JPMAM manages a wide variety of alternative funds that are sold in the European Union. These funds total \$20bn USD, as at June, 2011.

We welcome the opportunity to respond to ESMA's consultation on its draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive ("AIFMD"). Please do not hesitate to contact us if you would like to discuss any of the issues raised.

Q17 Fair treatment by an AIFM - Do you agree with Option 1 or Option 2 in Box 19? Please provide reasons for your view.

In this instance, we would be in favour of a maximum harmonisation solution (Option 1) in order to have clarity on the circumstances that would not constitute fair treatment. Without this, it is possible that different procedures will have to be in place in different Member States, which would be difficult for AIFMs to control effectively.

Box 21 Conflicts of interest policy

Box 21: We agree with the principles described in Box 21, however, it does not seem appropriate to include reference to "counterparty" in paragraph 2(a) as counterparties generally do not provide services "on behalf of" the AIFM but rather undertake transactions on their own behalf with the AIF. Please consider removing "counterparty" from the conflicts of interest policy requirement.

Box 31 and Q20 Special Arrangements – 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?

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We believe that the definition of “Special Arrangement” should be limited to those arrangements that do not apply to all investors. Accordingly, where an AIF’s prospectus sets out certain arrangements applicable to all the investors, these should be treated as normal arrangements. For example, if the redemption arrangements (such as gates) are described in the AIF’s prospectus, including the procedures that will apply to investors when liquidity becomes an issue, these procedures should not be treated as “Special Arrangements” of the AIF as these form part of the normal liquidity arrangements of an AIF. Notwithstanding the foregoing, we would agree that certain side pocket arrangements should be seen as a form of Special Arrangement.

Box 59 Review of individual values

Paragraph 1 is not clearly drafted. It appears to require that the values of all assets should be checked (or validated). If this is the case, it should say so. It also does not appear to be reasonable to document the assessment of appropriateness and fairness for every single asset; it may be perfectly reasonable for such documentation to reflect the processes by which a group of similar assets’ values are validated. There is no explanation of what an assessment of appropriateness might entail, or indeed what might or might not be appropriate. Some more guidance would be helpful here.

Q24 Objective reasons for delegation – Do you prefer Option 1 or Option 2 in Box 65? Please provide reasons for your answer.

We prefer Option 1, as it provides a high level criterion for delegation in a situation where all possible objective reasons cannot be listed in a regulation.

Box 66 Experience and good reputation of the delegate

We feel that it is not practicable for an AIFM to comply with paragraph 4 of Box 66 as it would not be possible for them to know with absolute certainty that there are no negative records. We would suggest reversing the standard of proof so that the persons conducting the business are not of sufficiently good reputation if the AIFM has actual knowledge of relevant criminal offences, judicial proceedings or administrative sanctions, having undertaken reasonable checks. In addition, we believe that the wording of explanatory text paragraph 29 should be included in the main Box wording for all jurisdictions (including non-EU) where reputation is assessed by supervisory authorities. Please see the suggested wording below:

“4. The persons who effectively conduct the business of the delegate should be considered to be of sufficiently good reputation if either:

- a. the delegate is authorised for the purpose of the delegated tasks and the criterion “good reputation” of the delegate has been reviewed by the relevant supervisory authority within the authorisation procedure, this criterion should be assumed as satisfied unless evident facts speak against it; or
- b. the AIFM, acting in good faith and having carried out reasonable checks, has no knowledge of any Negative Records relating to the relevant person, that are relevant both for the assessment of a good reputation and of the proper performance of the delegated tasks. “Negative Records” mean records of criminal offences, judicial proceedings or administrative sanctions in the jurisdiction where the delegated tasks are to be performed and that the AIFM reasonably believes to be relevant to the delegated tasks.

Box 67 Institutions considered to be authorised

Article 20(1)(d) of the AIFMD specifically allows authorised portfolio management companies to undertake delegated acts so long as cooperation between regulators is assured. It is not appropriate to limit the definition of “authorised or registered for the purpose of asset management and subject to supervision” to those that are authorised under certain EU Directives. Level 1 does not limit the requirement of authorisation to entities supervised by an EU competent authority, therefore, entities registered and supervised in a third country should also be included in Box 67.

Q 55. Any additional methods for increasing exposure – 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 many funds which have a benchmark portfolio, the primary method used to increase the relative performance is benchmark deviation in the physical investments. ESMA/2011/209 gives little insight into this method of risk taking. Of the various methods proposed by ESMA/2011/209 and CESR 10/788, only the VaR method in the latter shows the impact of this primary method of risk taking.

Q58: Exclusion of cash from gross exposure – 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 risk free rate and are held in the base currency of the AIF should be excluded?

When quantifying the exposure of an AIF we are in favour of the exclusion of positions which do not provide the target investment exposure of the AIF, including without limitation such positions as cash and cash-equivalents. Use of yield to identify risk-free positions, however, is unwise, in that (a) the comparison of the yield of positions with the yield of government bills of a defined maturity is a complex process not offered by many monitoring platforms currently in use, (b) yields of bills, and therefore prices, are manipulated by governments, at times volatile, and in the case of the Euro not consistent from government to government, and (c) the yield criterion excludes a range of instruments (reverse repos, AAA rated liquidity funds) which offer higher yields, default risk eliminated by collateral or reduced by diversification, and an absence of revaluation. This produces a conflict between the reporting standard and the best interests of investors.

Box 97 and Q56 Advanced Method of calculating exposure – ESMA has aimed to set out a robust framework for the calculation of exposure while allowing flexibility to take account of the wide variety of AIFs. Should any additional specificities be included within the Advanced Method to assist in its application?

Many AIFMs, including JPMAM, have a significant number of funds which are similar in their structure and investment techniques to their UCITS IV SICAVs which employ the VAR method, but which have been set up as AIFs because they have exposure limits suitable only for experienced investors. ESMA has elected to reject the use of VAR for all funds captured by the AIFMD, citing the exposure of the VAR method to the effects of the breakdown of correlations in stressed market conditions. We do not agree with this approach and suggest that VAR is included as a possible Advanced Method for calculating the AIF's exposure. We set out our reasoning below for completeness.

ESMA offers the Commitment Method, which is a modification of the CESR 10-788 equivalent, and the Advanced Method.

CESR 10-788 developed the commitment method to the extent that an automated implementation of the full commitment method was impossible. In particular it required daily calculation, which implied an automated monitoring process, but included decision points in the calculation requiring complex judgements which could not be programmed. In addition the duration netting process required optimisation calculations not offered by the best commercial monitoring platforms. This produced an inefficient hybrid process; part automated and part human intervention. Daily VAR, by taking into account all positions, represented an escape route from this computational impasse. Not only has ESMA/2011/209 blocked the use of VAR, but in offering the alternative Advanced Method it has made no provision for ceasing to calculate the Commitment Method when adopting the Advanced Method.

The proposed Advanced Method is essentially the same as the proposed Commitment Method with a relaxation of the rules regarding when netting and hedging can be used. As there is no regulatory limit on exposure, the output of the calculation per the Advanced Method risks being determined by a compromise between computational complexity, frequency of calculation and investor expectations, which could therefore lead to inconsistent reporting by AIFMs.

For the above reasons we would recommend that the reporting requirements of regulators charged with maintaining market stability should not also determine the risk control methods permitted for asset managers, and in particular that VAR be a permitted Advanced Method where, in the opinion of the AIFM, this is appropriate for the particular AIF.

Please also note by way of a general comment on the proposed methods that the range of funds covered by the AIFMD is too diverse to permit the specification of the Advanced Method to usefully go beyond a statement of basic principles.

Box 106 Content and format of remuneration disclosure

If further information has to be provided where an AIFM opts to show the total remuneration for its entire staff, it would be helpful if the information in explanatory text Paragraph 27 were to be included in the rule. Please note that this would have to be done on the basis that Paragraph 27 is without prejudice to the principles laid out in Box 106(3) which provides that the breakdown should only be provided “insofar as this information exists or is readily available”. Please also note that the use of “or” in the quoted phrase is inappropriate since the information must exist for it to be readily available. Therefore “and” should be used instead.

Q66 Special Arrangements – Do you agree with ESMA’s proposed definition of special arrangements? What would this not capture?

We do not agree with the definition. As stated in our comment on “Box 31 and Q20 Special Arrangements” above, we understand a “special arrangement” to be a bespoke or separate arrangement from the procedures applicable to all investors. Please also refer to our comment in “Box 31 and Q20 Special Arrangements” in respect of gating and side pockets.

Box 107 and Q67 Periodic disclosure to investors – Which option for periodic disclosure of risk profile under Box 107 do you support? Please provide reasons for your view.

Our preference is for Option 1 as, in our view, this is more likely to be understood by investors. The stress testing results in Option 2 are unlikely to be sufficiently consistently calculated to be of value to investors and they are less likely to be understood.

Box 109 Format and content of reporting to competent authorities

The proposed frequency of reporting under Box 109(1) appears to be excessive given likely costs incurred in producing the required information. We propose that this should be changed to an annual requirement which would be more appropriate.

The volatility calculation required under Box 109(3)(d)(i) may be impossible to calculate for those funds which are priced infrequently, because of the lack of data elements.

In Box109(3)(e), a standardised definition of turnover should be provided, in particular stipulating the treatment of cash management processes.

Many funds may find it impossible to provide information required under Paragraph 3 within a one month timeframe owing to the nature of the assets held.

Regarding Box109(6), a conceptual conflict has been identified between Directive 2011/61/EU and the ESMA consultation. In Article 24(4) of 2011/61/EU, leverage is required to be broken down into the following sources: borrowing of cash, borrowing of securities, financial derivatives, and reuse of assets under leveraging arrangements. This largely reflects the incremental exposure concept: that is exposure in excess of that obtained from physical investment positions, as employed in global exposure per CESR 10/788. In 2011/61/EU, leverage is defined as exposure as measured by the Gross Method, Commitment Method and Advanced Method, which include other asset or liability positions. An aggregate measure (physicals excluding cash and cash equivalents yielding risk free, plus derivatives, plus off balance sheet exposures) is adopted in the current consultation to express an incremental concept in the Directive. A significant weakness of the commitment method as defined in CESR 10-788 is the failure to take into account volatility in unit pricing caused by benchmark deviation in physicals. For this reason, while noting the conflict between 2011/61/EU and ESMA 2011/209, we do prefer the treatment in the latter document.

Q71 Reporting deadline – 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?

The deadline is too close to the end of the reporting period for many AIFs, especially for those with property portfolios or other less liquid assets that take time to value. We would suggest that a three month deadline would be more appropriate.