Alternative Investment Management Association

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

13 September 2011

Dear Verena

AIMA welcomes the opportunity to submit its comments on the Consultation paper on ESMA's draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive (AIFMD). AIMA is a global hedge fund association with a unique presence in the EU. AIMA's membership comprises over 1,200 firms in more than 40 countries around the world. As of December 2010, AIMA had 538 member companies in 14 EU member states. Of those members, 252 are single hedge fund managers managing between them approximately €250 bn ($320 bn). We estimate this represents approximately 70 % of the total assets under management of the entire EU hedge fund industry, making AIMA the most representative EU hedge fund industry body.

AIMA recognises the exceptional difficulty inherent in the task of advising the Commission on the substantial number of implementing measures of the AIFMD in such a short period of time. In our view, ESMA has to date successfully met this challenge and managed to balance a number of different and complex considerations. AIMA appreciates the openness and willingness to engage with the affected stakeholders that has been displayed by ESMA, evidence of which includes both the technical workshops and the extensive consultation process. ESMA's open and independent approach will contribute to the overall quality and objectivity of the advice. As the original AIFMD proposal was not accompanied by a thorough impact assessment, the Directive negotiations were the subject of extensive political debate and compromise resulting in a comprehensive redrafting of the initial proposal. It is therefore all the more important that a strong independent body with invaluable expertise such as ESMA, formulates balanced and workable advice that is, as far as possible, based on evidence and existing regulatory and market practice.

Overall, AIMA believes that ESMA's draft advice is measured and adds useful clarification and detail to the AIFMD text. It is clear that ESMA has recognised that the diversity of the entities which are likely to fall within the scope of the AIFMD, requires that proportionality and flexibility are applied to many if not most of the areas subject to implementing measures. Although AIMA is also pleased to see that many provisions have been based on the text of the UCITS or MiFID directives, we do believe there are some areas where further adjustment of those texts is necessary in order to take account of the differences between more traditional asset management regulation and the alternative space. Moreover, the draft advice seems to go beyond what is currently required by these directives in some particular areas and we would query whether such an approach is warranted given the professional nature of the markets the AIFMD will regulate.

AIMA would therefore urge ESMA to further develop the concept of proportionality in the advice, considering the breadth of the scope of the AIFMD. This is all the more pressing in light of the Commission's recent public recognition that some AIFM might struggle with several of the requirements

of the AIFMD and that those requirements may be unduly burdensome given the sophisticated nature of the investor base and the fact that the entities covered by the directive are not systemically important[1].

AIMA believes that, in order to make the final implementing measures workable and effective, the legal text should, wherever possible, rely on principles, backed by appropriate guidance, rather than develop detailed and prescriptive rules. Prescription could risk setting inappropriate limits on what is permitted and, in so doing, lead to an unintended reduction in the breadth of existing business models or strategies or significant loss of innovative potential for the EU alternative asset management industry. Any unwarranted increase in costs or loss of choice will be imposed upon investors, many of whom are EU investors. We also urge ESMA, when formulating the final technical advice, to continue taking account of the costs and other impacts associated with significant changes, which is of course vital for a competitive European asset management industry going forward and for the investors who rely on access to specialist investment management techniques.

Notwithstanding our overall positive assessment of the draft technical advice, AIMA has a number of serious concerns regarding some of the proposals, in particular those relating to depositaries, leverage, valuation, transparency and liquidity management. We believe that particular attention should be paid to these areas when finalising the technical advice. Some of the proposals in these areas have the potential to render the regulatory framework disruptive to a point of it becoming prohibitive to conduct alternative investment business in the EU.

Depositaries – the liability related issues and the operational complexities associated with some of the proposed options could dramatically drive up costs or cause depositaries to withdraw from certain markets. Under an adverse impact scenario, we estimate that the increase in costs for depositary services could range between 100 to 150 basis points, meaning that the cost of AIFMD to hedge funds could amount to more than US $6 bn with equal on-going costs per year.

Leverage – an inappropriate measure of leverage could result in hedge funds reporting levels of leverage which are unrealistic and unrelated to the actual levels of exposure in the industry. Definitions of leverage which are extremely far from the current market practice have the potential to cause extreme confusion in the investor community. Furthermore, it would be difficult to understand the benefit gained by the ESRB in receiving leverage levels which are not comparable to the way leverage is proposed to be calculated in the banking sector. Finally, we believe that the criteria and circumstances under which competent authorities may restrict AIFM's levels of leverage are simply too broad and do not contain adequate safeguards in order to protect investors' property rights.

Valuation – we believe that when a third party administrator carrying out the calculation of the AIF's net asset value is appointed by the fund governing body, this administrator should be considered to be an external valuer subject to the provisions of Article 19 of the Directive. An opposite interpretation of the text seems to be counterintuitive and difficult to reconcile with the provisions of the Directive.

Transparency - in regard to reporting to competent authorities, we would urge ESMA to seek greater global consistency in this field, both in terms of frequency, timing and of content of reporting. Inconsistent requirements not only impose unnecessary costs on managers but also prevent comparability of data collected by different regulators. We believe that the frequency of reporting that is currently proposed is not proportionate for all AIFMs and that a tiered reporting obligation should be considered.

Liquidity - AIMA has certain concerns in relation to ESMA's proposals on liquidity management. In particular, we disagree with the definition of "special arrangements" and the inclusion of mechanisms such as gates which we regard as a prudent method for managers to ensure that redemption requests can be met. There are compelling arguments that, rather than being a bar to liquidity, gating mechanisms are in fact there to provide an aid to liquidity, by providing a mechanism whereby the liquidation of assets in the portfolio can be managed in an orderly fashion so as to avoid situations where genuine "special arrangements" (such as the utilisation of side pocket mechanisms or the application of suspension powers) need to be applied. It is very often the case that gating provisions are included

[1] See page 5 of the Commission's consultation paper A New European Regime for Venture Capital – http://ec.europa.eu/internal_market/consultations/docs/2011/venture_capital/consultation_paper_en.pdf

specifically so as to provide exposure to assets where liquidity is somewhat limited in a manner which ensures that no investor is disadvantaged by the actions of others when seeking to withdraw assets from the fund. It would, therefore, be useful to move away from the preconception that the starting point for consideration of liquidity terms should be that all investors should be able to redeem all of their investments in the fund at the same time on the same day with no impact on the price at which the redemption is effected.

We would urge ESMA, wherever possible, to work towards solutions based on achieving a regulatory outcome, accepting that AIFMs in different sectors should be able to apply the legislation in different ways, based upon the nature of their particular business models. It should not be seen as a failure if a single legislative provision is unable to describe and prescribe the right models for all AIFMs – the measure of success, instead, should be to afford AIFMs, regardless of their business model, their size or the complexity of their undertakings latitude to comply with the Directive in a meaningful manner.

Regulation or Directive?

Although not the subject of this consultation, AIMA would like to set out briefly its views in relation to the choice of legislative instrument. AIMA strongly believes that the implementing measures should be adopted in the legal form of a directive, rather than a regulation. The main reason for this is that the diversity of legal structures of AIFMs and AIFs will require that the implementing measures can be adapted to the particularities of national laws.

As regards the provisions relating to depositaries, AIMA believes that it would be nothing short of devastating to use a regulation. At a superficial level, it may seem tempting to use a regulation as it would be directly applicable and pre-empt the application of national provisions within its area of application. However, the use of a regulation will introduce significant legal uncertainty as it will inherently interact with areas of law which are not capable of being harmonised by the regulation yet are extremely important in delivering the regulatory objectives of the Directive. As EU law does not generally harmonise civil law or the terminology associated with it, a regulation on depositaries would amount to a harmonisation *in casu* and would need to be supplemented with national concepts of civil law which are not harmonised.

Hence, a regulation is likely to create far-reaching and unforeseeable effects in the domestic legal systems which, given the links to banking regulation, will have an additional direct impact on the capital levels necessary to carry out the depositary activity, increased concentration and interconnectedness in the depositary sector and an associated increase in systemic risk. We feel that the benefits of greater harmonisation can be perfectly obtained by using tightly drafted and detailed directives without incurring the costs of legal uncertainty associated with overlapping European and Member States' liability regimes and property laws.

Furthermore, there are a number of areas where the advice is not adequately tailored to the different legal structures of AIFMs and AIFs. For example, the section on control by management and supervisory function (Box 48) and accompanying Explanatory Text, makes reference to the directors of the AIFM. In many cases AIFM will be structured as limited liability partnerships which will not have directors but partners. There are a number of similar issues in the advice, where certain legal structures are not catered for. In some areas there also appears to be some confusion as to whether a certain task is carried out or delegated by the AIF or the AIFM, as this will inherently depend on the legal structure of the AIFM and AIF. AIMA is concerned that a regulation would not succeed in adequately tailoring the requirements to different legal structures, the effect of which could be extremely disruptive to large parts of the industry.

That said, we can see value in the use of a regulation in the area of disclosure requirements to national competent authorities since we believe that a high level of harmonisation here is not only achievable but also desirable. It could greatly contribute to the comparability of information collected by national competent authorities and thereby have a positive effect on supervisory cooperation.

Conclusion

AIMA supports the overall approach ESMA has taken in its draft technical advice. AIMA encourages ESMA's independent reading of the Directive with a focus on evidence-based policy making. We strongly urge ESMA to give serious consideration to AIMA's proposals in the areas of depositaries, leverage, valuation, transparency and liquidity management. These are often new areas of regulation where we believe ESMA may face additional complexities when formulating its technical advice, areas where further consideration may be needed to take account of the different types of managers who are covered by the scope of the directive. Where possible, AIMA has striven to provide a detailed legal analysis as well as an economic impact assessment in order to assist ESMA better in its deliberations. We hope you will find our submission helpful and stand ready to be of assistance and answer any questions you may have in relation to its content.

Yours sincerely,

Andrew Baker
Chief Executive Officer

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

13 September 2011

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1 Article 3 exemptions (section III)

1.1 Introduction

Overall, AIMA favours an approach to Article 3 which is simple and relies on widely used ways of calculating assets under management. The net asset value should serve as the basic measure for the purposes of identifying whether the AIF has reached the prescribed threshold. The net asset value also automatically includes assets which have been acquired through leverage and so meets the basic requirements of the directive.

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

1.2.1 Calculation of the total value of assets under management (Box 1)

We think it would be useful to clarify the availability of the Article 3 exemptions for AIFM who manage AIF that fall within Article 3 (2)(a) and AIF that fall within Article 3(2)(b). Given that the thresholds are calculated by reference to aggregate assets of AIF under management by entities under common control or through substantive holdings, it is likely that this will catch many management groups who manage AIF falling in both Article 3(2)(a) and Article 3(2)(b). For example, we think it would be unreasonable for an AIFM who would otherwise be eligible for the exemption in Article 3(2)(b) to be prevented from using the exemption simply because it managed a single AIF that was not eligible under Article 3(2)(b) because it could not meet the requirement that "… the portfolios of AIF consist of AIFs that are unleveraged …". Similarly, there is logic in permitting AIFM to avail of the higher threshold in Article 3(2)(b) to the extent the AIF they manage qualify for the Article provided that AIF they manage that do not qualify for the higher threshold meet the threshold in Article 3(2)(a).

Assets which are managed by the AIFM under an individual portfolio mandate should be excluded from the threshold calculations. We also believe that further consideration should be given to the way assets managed by third country AIFMs are to be identified for the purposes of Article 3.

In addition to our comment above, we have the following drafting comments:

- In line 6 of paragraph 3 of the text in Box 1, we believe the word "or external" should be added between "internal" and "AIFM".

- In line 2 of paragraph 5(b) of the text in Box 1, we believe the word "materially" should be added between "period" and "in" in line 2. This is relevant because redemptions will often take effect on the first day of a month following the valuation day on the last day of the prior month. If the curing event is a redemption, without this flexibility the effective period might be only 2 months.

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 believe that the requirement for the net asset value prices for AIF to be produced within 12 months of the threshold calculation should not be problematic for most AIF provided sufficient flexibility is provided as to the nature of that valuation.

While many AIF will have readily available valuations for this purpose, some AIF will not have readily available valuations (particularly where they are closed-ended). We believe adequate flexibility will be provided where:

- AIF are permitted to use the valuation methodology adopted by the AIF's governing body provided this is permitted by the governing law of the AIF's jurisdiction of domicile.

- Where routine valuations are not such that valuations are readily available within 12 months of the threshold calculation (for specific assets or generally), it would be necessary to provide flexibility to allow the relevant assets to be carried at cost or, if available, adjusted to reflect any interim revaluation. This would otherwise impose inappropriate cost burden in order to produce these valuations contrary to the Commission's "principle of proportionality".

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

We do not think that a single date should be set for calculation of the threshold. While 31 December in each year may be the most convenient date for many AIF, there will be many exceptions depending on, amongst other things, where the AIF are domiciled. Therefore, to impose a single date may require AIF to conduct valuations specifically for this purpose (incurring further costs for the AIF and its investors). We believe that giving the AIFM flexibility to determine the timing (together with the proposed requirements for changing the threshold date) is an appropriate approach.

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.

Provided the flexibility referred to in our response to question 1 is provided, we believe that an annual net asset value calculation will be appropriate for most funds and is therefore the correct approach.

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?

There may be circumstances where a re-calculation of the threshold is not necessary. For example if there were a significant redemption request submitted, if an asset has been written down or written off, if there is an interim event on the basis of which is possible to apply a lower valuation to an asset (such as a market sale or IPO). In any event, given that many funds will not produce formal valuations on a quarterly basis, we believe it would be appropriate to allow the recalculation of the threshold to be calculated on the basis of reasonable estimates. To require formal valuations across the entire range of AIF managed by an AIFM would be unduly onerous where these valuations would not customarily be produced, particularly as the Directive does not regulate AIF.

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

As AIFM availing of the exemption under Article 3 will still be required to report information for the purposes of monitoring systemic risk, we think it is appropriate to align the exemption in Article 3 with that provided in Article 61 and allow these AIF to be discounted.

1.3 Influence of leverage on the assets under management (section III.II)

1.3.1 Summary

Broadly speaking, the net asset value is obtained by calculating the value of all assets acquired by the AIFM, including the value of the assets which have been acquired via leverage such as borrowing or other arrangements and subtracting the value of the AIF's liabilities. This why we believe it is the measure which meets the requirements of the Directive without any further adjustments.

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?

AIMA is strongly against this. We think that the gross leverage is often a nonsensical measure of leverage and should not be used at all, and especially not for measuring AUM.

Banks, regulators, investors and the public at large already have a common understanding of what AUM means, and we strongly recommend that ESMA gives guidance to use the same definition. AUM can be defined as the amount of capital under management *from investors*, or alternatively the *net asset value* of the fund. This concept will include any leverage provided by investors to the fund, if, for example, investors subscribe to the AIF by purchasing units of debt issued by the AIF. This definition also meets the requirement that it includes "assets acquired through leverage" as stated in the level 1 text. And although it is not stated in the level one text, it also includes liabilities acquired through leverage. To interpret "assets under management" as meaning that the thresholds in Article 3.2 be calculated by reference to "gross exposure" would be disproportionate. In addition it would result in a potentially significant number of extremely small AIFs and AIFMs be captured by the Directive.

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?

Yes, these positions are used to decrease the exposure of the fund.

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?

No, because Box 2(2) explicitly says that AIFMs should calculate leverage using the gross method and implies that this should impact the measurement of AUM. However, excepting this specific sentence, and subject to our answers to Q6 above, the process of calculating AUM is clear.

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

1.4.1 Summary

We are generally supportive of ESMA's proposals here but consider that quarterly reporting is too onerous.

1.4.2 Information to be provided as part of registration (Box 3)

We have the following comments in relation to the requirements to provide information as part of registration:

- Box 3 paragraph 1: In relation to the proposal to require the details of the value of AIF in relation to Article 3(3)(b), we think it appropriate that the same flexibility is afforded as set out in our response to Question 1 above.

- Box 3 paragraph 4: We think that requiring information to be provided quarterly is too onerous for exempt AIFM, particularly given the powers proposed in paragraph 5 of Box 3 which would enable such information to be obtained on an interim basis if considered necessary.

1.5 Opt-in procedure (section III.IV)

1.5.1 Opt-in procedures (Box 4)

We agree with ESMA's proposed approach to opt-in procedures.

1.5.2 AIFMs falling below the threshold (Box 5)

We have no strong view on ESMA's proposal in this regard. However, as authorisation under the Directive is optional for AIFM that fall below the thresholds in Article 3, we believe that Box 5 would be better expressed as a simple requirement only to take action if the AIFM wishes to seek exemption. This might avoid any inference in the current wording that action may be required simply by virtue of falling below the threshold.

2 General operating conditions (section IV)

2.1 Introduction

We broadly support the approach taken in many parts of this section IV to follow principles of regulation that already apply through other EU Directives, most notably MiFID and the UCITS Directive. This will enable regulated firms and groups to adopt a single, uniform approach to compliance on various aspects of their operation and avoid the need for managers that are already regulated to adjust existing requirements imposed through MiFID or being required to comply with slightly differing but otherwise duplicative requirements. We identify areas, however, where it would be helpful to pursue this uniform approach further – for example in relation to conflict management. We also identify examples where due to the nature of AIF and their management, principles of regulation that apply elsewhere are not suitable here. An example of this would be in relation to the proposed use of the Advanced Measurement Approach to calculate capital requirements.

As with other areas of our response, we support proposals in many parts of this section IV to apply rules in a flexible manner dependent on the size of fund and business concerned and the asset classes involved. We identify areas in this section where we feel this approach has been appropriately applied and other areas where we feel this approach might be pursued further.

2.2 Possible implementing measures on additional own funds and professional indemnity insurance (section IV.I)

2.2.1 Summary

We have a number of concerns in relation to the detailed proposals in 2.2. In particular, we consider that the proposed application of the Advanced Measurement Approach is unsuitable to alternative fund management and we are concerned that the proposals relating to PII are unrealistic in relation to how that market operates in practice.

As regards the calculation of own funds, we believe that out of the proposed options, Option 1 is the more appropriate as it simple to calculate and satisfies the basic requirement of the Level 1 text. Whichever option is chosen, however, we would urge ESMA to consider a cap for the overall capital requirement. This is fully in line with the logic of the Directive which also introduces a limitation on the amount of own funds the AIFM must hold.

2.2.2 Description of potential risks (Box 6)

We broadly support ESMA's proposal for professional liability risks to be covered by additional own funds or professional indemnity insurance. However, a number of changes must be made in order to make this proposal work. Without these changes, we believe it will be impossible to purchase professional indemnity insurance meeting the required criteria.

The reference to "relevant persons" should be replaced with a reference to "AIFM's staff". The definition of "relevant persons" has been copied from MiFID, where it is used in a completely different context, namely to regulate personal account dealing. In that context, we agree it is appropriate to require a firm to put in place procedures which cover both its own staff and the staff of a third party who might commit market abuse based on information obtained from the firm. However, the Level 1 text is clear that the own funds/PII requirement relates only to the professional negligence of the AIFM, not to that of delegates appointed by the AIFM. We doubt that AIFM could purchase PII cover for the acts of relevant persons who are third party delegates. We note that this change will mean that an AIFM's responsibilities in relation to appointing delegates will be covered by PII. Where the AIFM has appointed a delegate, it will have professional responsibilities in relation to that appointment as determined by the applicable law. This issue is covered in Box 6 by reference to "negligent acts, errors or omissions by the AIFM resulting in a breach of… duty of skill and care to the AIF when carrying out its professional activities".

Business disruption and system failures are not an AIFM professional negligence issue. They should be deleted as they are outside the scope of Level 1 and outside the scope of PII cover. Professional negligence issues relating to process management are already covered in paragraph 2(b). Paragraph 2(c) needs to be deleted in order for Box 6 to be a workable set of criteria for PII cover.

Our comments are based on the position in the UK, which is the most developed European market for professional indemnity insurance for AIFMs. We note that in a number of EU jurisdictions, there is no developed market for professional indemnity insurance for AIFMs. If the proposed list in Box 6 is made mandatory, there is a risk that other markets will be adversely impacted, as in practice AIFMs will be unable to obtain PII cover meeting the prescribed requirements. If instead of making these requirements mandatory, the Level 2 text were to require AIFM and competent authorities to "have regard to" the list of issues in Box 6, this should facilitate AIFM in those other jurisdictions obtaining PII cover.

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 it feasible and/or practicable for an AIFM to attempt to obtain professional indemnity insurance in relation to the valuation performed by an appointed external valuer. The AIFM will be subject to professional duties when appointing the external valuer and should be able to purchase professional indemnity insurance to cover breach of duty regarding that appointment. However, an AIFM will not be able to purchase PII to cover the negligent performance of acts by a third party (such as independent valuers).

2.2.3 Qualitative Requirements (based on Annex X Directive part 3 2006/8/EC) (Box 7)

This proposal is derived from the "Advanced Measurement Approach" used by the world's largest banks, which are subject to Basel 2. We do not believe that any AIFM will have sufficient historic loss data to make use of this methodology workable. We strongly advocate that this is deleted from the proposals.

2.2.4 Qualitative Requirements (Box 8)

We do not have any comments in addition to our responses to the questions below.

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 consider that the level of fees received are an appropriate approximation to determine the risk of professional negligence posed by an AIFM. In relation to performance fees, we suspect that there is more likely to be an inverse correlation between the levels of the fees (which reflect underlying fund performance) and losses.

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')?

For the reasons given above we do not advocate using income as an approximation for professional liability risk. We recommend this option is deleted.

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?

For the reasons given above, we consider the AMA approach should not be used for AIFMs.

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?

For the reasons given above, we consider the AMA approach should not be used for AIFMs.

2.2.5 Professional indemnity insurance (Box 9)

We have a number of concerns in relation to the proposal for professional indemnity insurance.
Our first concern is the use of the term "relevant persons" in paragraph 1 (b) which we propose, for the reasons given in section 2.2.2 (Box 6), is replaced by "AIFM's staff".

Secondly, we are very concerned by the proposal in paragraph 1(c) that there be no exclusions regarding liability risks. Every insurance policy has exclusions and professional indemnity insurance is no exception, AIFMs will simply be unable to buy PII without carve-outs. We propose that this reference is deleted and that it be made clear that carve-outs may apply in accordance with normal insurance industry practice. Providing a definitive list of exclusions would be difficult, if not impossible as there is no market standard list of exclusions, just as there is no market standard form of insurance policy. Different insurers cover different exclusions. Policies would normally exclude (among other things) losses relating to:

- Institutionalised fraud, deceit, etc. on the part of the AIFM (this is not amenable to insurance where the AIFM has itself committed an offence);
- Investment performance guaranteed or guaranteed rates of return (as these are not insurable risks);
- Destruction, theft or loss of, or damage to, property (other than loss of documents) which would typically be covered by a different type of insurance, such as buildings contents insurance;
- Injury, sickness, death (not a subject for professional negligence);
- Claims that should be covered under a previous policy;
- Breach of contractual warranties and undertakings to the extent that these go beyond the legally mandated standard of care.

Other market standard exclusions arise from time to time. For instance, at the end of the 1990's a number of policies excluded liability for Year 2000 computing risk. It is vital that the level 2 measures accommodate the need for carve-outs which are customary in the professional indemnity insurance market and take account of the fact that policy exclusions are not static but change from time to time with market conditions and vary from insurer to insurer.

Thirdly, we do not agree with the proposed restriction in paragraph 1(f) that insurance must be provided by a third party entity and, in the case of insurance through an affiliate, must be laid off to an independent third party entity. Where the criteria set out in paragraph 1(e) are met, there is no need to impose this additional restriction.

Finally, we also have some concerns about the practicality of complying with the proposed ongoing review requirement in paragraph 4; we would propose this is restricted to an annual review and in the event the AIFM:

- launches a new fund or in the case of a self-managed when there is new fund raising;
- closed down a fund;
- opens an office in a new jurisdiction; or
- has notified a claim to insurers.

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.

We do not support the proposal implied in question 15 of setting a lower minimum amount for single claims but higher amounts for aggregate claims. A "claim" in the context of PII means a claim made by the AIFM against the insurer. That claim may relate to amounts paid to multiple investors who have brought legal actions against the AIFM relating to the same default (e.g. negligent deviation from the investment policy). We do not think it would be helpful to add in a concept which refers to the number of persons who might bring a claim against the AIFM in relation to a particular matter.

2.3 Possible implementing measures on general principles (section IV.II)

2.3.1 Summary

While we broadly support the proposals in this section, we do have some concerns over the proposed extent of some of the proposals, in particular those relating to selection and appointment of counterparties and prime brokers and relating to inducements.

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 believe that the term 'business plan' could be used.

2.3.2 Selection and appointment of counterparties and prime brokers (Box 13)

We propose that the reference to counterparties should be removed as the inclusion of counterparties is not mandated by Article 14(3) of the Directive and is thus neither required, nor permitted by the Level 1 text. Further, to require all counterparties to be "subject to ongoing supervision by a public authority" would exclude many counterparties from consideration by an AIFM. Moreover, "public authority" is not defined and, given that counterparties could be located in any part of the world, any definition would be difficult, if not impossible, to frame. If ESMA believes that counterparties should still be covered by the selection and appointment requirements, we propose that the requirements are narrowed to only apply in relation to transactions involving derivative contracts not covered by the requirements set forth in EMIR which have maturity of at least one year. We do, however, broadly support that the selection and appointment requirements are applied in relation to prime brokers.

In addition to the above, we also believe it would be helpful to clarify what is meant by 'exceptional case' in paragraph 2 second sentence and in what way senior management approval in this case is different from senior management approval in paragraph 2 first sentence.

2.3.3 Inducements (Box 18)

We broadly support ESMA's inducement proposal. However, we believe that there is a general problem with applying the UCITS Directive Level 2 rules on third party marketing. Third party marketing firms are an important part of the hedge fund industry in the process of raising capital and expanding the investor base, especially for start-up funds. In many cases, third party marketing firms provide hedge fund managers with the resources to reach out to potential investors that the fund would not be able to reach on their own. Many hedge fund managers hire third party marketing firms because the hedge fund manager's core expertise is usually in managing the portfolio for investors, and not establishing new relationships with potential investors. In exchange for these services, third party marketing firms normally charge a percentage of the fees received from assets invested in the hedge fund as a result of their efforts. We are concerned that it will be difficult for hedge fund managers to continue to apply the current third party marketing fee model under the proposed inducement rules since third party marketing generally does not 'enhance the quality of the services'. This would seriously complicate the process of raising capital and expanding the investor base, especially for start-up funds and smaller hedge fund managers.

Against this background, we would propose that the requirement to 'enhance the service' in paragraph 1(b)(ii) is amended as regards marketing services by amending the wording to 'must not impair the quality of the relevant service'.

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

We do not believe it would useful to define the concept of fairness either per se or indirectly by use of an example. Our view is that the proposed options, both 1 and 2, are too broad and too ambiguous. We believe that fair treatment is upheld by requiring AIFMs to disclose the existence and nature of preferential treatment. However, if ESMA believes that it is necessary to further expand on the concept of fair treatment, we would argue that Option 1 is preferable. The reason for this is that Option 1 provides maximum harmonisation which is less likely to lead to ambiguity. Additionally, we do not believe that the explanatory text is reflected in the Box and we would welcome further clarification.

2.4 Possible implementing measures on conflicts of interest (section IV.III)

2.4.1 Summary

We support the main thrust of the proposals on conflicts of interests, which is to broadly equate requirements with those that already apply to regulated firms under MiFID – thereby allowing regulated groups to adopt a single, broadly uniform policy on conflicts of interest. Indeed we identify a further example where the AIFMD approach on conflict management should be brought further into line with MiFID and UCITS Directive. We also welcome the explicit recognition, in common with how conflicts of interest requirements are applied under MiFID, that conflict management policies should be proportionate to the scope of a firm's business.

2.4.2 Types of conflicts of interest between the various actors as referred to in Article 14(1) (Box 20)

In our view as is the case in MiFID (Article 21, Level 2) and the UCITS Directive (Article 17, Level 2), the requirement to identify conflicts should be clearly limited to those that may be potentially detrimental to investors or the relevant AIF. We would therefore suggest to include "*and whose existence may damage the interests of the AIF or its investors*" after "*that arise in the course of managing AIFs*" to bring the proposal in line with MiFID and the UCITS Directive. It would also be helpful if it were made clear that the requirement to identify conflicts only relates to those conflicts that may be detrimental to investors or the relevant AIF. This will allow AIFM's to focus their conflict management efforts appropriately to achieve the main policy objective here whilst also achieving consistency with MiFID and the UCITS Directive and thus allowing regulated firms and groups to adopt a single conflicts policy to cover all regulated activity.

We finally note that the reference to "*interest of one investor over the interest of another investor or group of investors of the same AIF*" in paragraph 1(c) does not occur in the conflict of interests rules of the UCITS Directive but is covered by UCITS conduct of business rules.

2.4.3 Conflicts of interest policy (Box 21)

We welcome the reference to conflicts of interest policies being proportionate to the nature, scale and complexity of an AIFM's business and the general consistency with MiFID. However, the reference to "*including* activities carried out by a delegate, sub-delegate, external valuer or counterparty" in paragraph 2(a) is not expressly included in MiFID (Article 22, Level 2) nor the UCITS Directive (Article 18, Level 2). There is language in MiFID and the UCITS Directive, however, to the effect that where activities are carried out on behalf of the firm/management company, conflicts of interest policies should identify circumstances which constitute or may give rise to a conflict of interests of one or more clients. Our main concern here is to ensure that an AIFM is not required to take on full liability for conflict management policies of third parties. It would be helpful therefore if the language here were to replicate or more closely follow the language of MiFID – making clear that conflict identification

obligations should apply where functions are delegated but not imply that an AIFM is fully liable for the acts of its delegate.

2.4.4. Independence in conflicts management (Box 22)

We support the consistency in this language with the parallel provisions in MiFID and the UCITS Directive which is conducive to regulated firms and groups developing a single policy on conflicts management.

2.4.5 Record keeping of activities giving rise to detrimental conflicts of interest and way of disclosure of conflicts of interest (Box 23)

We refer to our comments in section 2.4.2 (Box 20) above. In addition, the reference to Article 14(1) in the proposed paragraph 2(a) gives rise to a risk that this obligation would cover any conflict of interest as opposed to the more limited scope of conflict of interests (i.e. those that are potentially detrimental to clients as per MiFID (Article 22 (3) Level 2)). Our suggestion would be to delete the reference to Article 14(1), therefore. We would also propose to amend the reference to "*where a delegation or sub-delegation of portfolio or risk management has taken place, conflicts of interest between the delegate or sub-delegate and the AIFM or the investors of the respective AIF*", please see response in section 2.4.2, since this language is not reflective of MiFID or the UCITS Directive.

2.4.6 Strategies for the exercise of voting rights (Box 24)

We broadly support ESMA's proposal. The disclosure method in paragraph 3 is less onerous than under the UCITS Directive which requires that details of the actions taken on the basis of those strategies should be made available to unit-holders free of charge upon their request. In this instance we note and support the divergence from the UCITS Directive. Bearing in mind the types of investors in AIFs and noting that AIFs vary considerably in size and scale, it seems appropriate that the option is apparently left open for AIFs to charge for this.

We would propose that paragraph 1 and 2 be applied in a manner that is proportionate to the size/activities of the AIF. An additional consideration is whether there should be an exemption where information is potentially market sensitive or disclosure would be significantly prejudicial to the overall commercial interests of the AIF/investors as a whole.

2.5 Possible implementing measures on risk management (section IV.IV)

2.5.1 Summary

The principal issues with the proposed text centre around policies which go beyond those which are found in the MiFID Directive. It is difficult to see the justification of imposing stricter requirements on AIFMs. We strongly support the policy which recognises that it may not be proportionate in all situations to require separate dedicated personnel to carry out the duties associated with the risk management function.

Regard also needs to be had to the wide range of AIFMs, and the AIFs that they manage, which will be regulated by these provisions. Care should be taken to ensure that the level 2 text does not go beyond the Level 1 concepts, nor imposes more stringent requirements than is the case for other AIFs that are not regulated by the Directive, to minimise "shopping" between different regulatory regimes.

2.5.2 Permanent risk management function (Box 25)

To ensure that the guidance in relation to risk management is interpreted and applied on a consistent basis, we would suggest that the reference to a "permanent" risk management function instead refer to a "functionally or hierarchically separate" risk management function, unless "permanence" is intended to refer to a different quality (which would then need to be explained in more detail).

We would also suggest that the reference to "effective" risk management policies and procedures in sub-paragraph 1(a) be linked to an element of proportionality, as has been proposed elsewhere (for instance, in relation to Box 30, paragraph 2).

It is unclear what other functions are permitted to fall under "risk management" so that the risk management function is treated as functionally or hierarchically separate and further advice on this would be welcomed. By way of example, and whilst we acknowledge that there may not always be a functional and hierarchical separation as contemplated by sub-paragraph 3(e) of Box 26, can there be any derogation from the requirement for separation to enable the individuals that work in risk management to carry out other tasks (and, if so, what other tasks would be permissible)? This would be particularly relevant for smaller managers.

The text in the last line of sub-paragraphs 1(c) that reads "where it is aware... limits" and the words "foreseeable breaches" in 1(e) is too wide. It is an unduly onerous burden for AIFM to be expected accurately to forecast risk in this way and this language could be used to impose sanctions with the benefit of hindsight. We would recommend deleting these words.

Consideration should be given to whether the focus should be on first identifying relevant material risks and then measuring, managing and monitoring the risks that have been identified.

2.5.3 Risk management policy (Box 26)

In relation to sub-paragraph 3(b), we believe that there should be an acknowledgment that the liquidity concerns of AIFs will depend on their investment strategy and focus (for instance, liquidity will be of lower concern for AIFs that do not offer their investors any liquidity at all).

There is a focus on conflicts of interest here and in Box 30 – whilst conflicts of interest are undoubtedly important, these are matters that should already be clearly disclosed and we would suggest that no undue focus is put on this issue.

It is unclear to whom the risk management policy should be made available, and how. Further guidance should be provided on this, with a key element being that any (non-investor-facing) disclosure is limited to the regulator (who should be required to treat the information confidentially) so that an AIFM's know-how is not required to be made available in an uncontrolled way. We believe that there will in any event be a move by AIFM to share know-how but this should not come through a forced disclosure of proprietary information.

In relation to sub-paragraph 3(e), we believe that there should be a focus on ensuring that the safeguards are applied, rather than creating a requirement for more paper documenting compliance.

2.5.4 Assessment, monitoring and review of the risk management policy (Box 27)

It is unclear how any assessment, monitoring and review should be documented, especially if no material change need be made to an AIF's risk management policy. Should AIFM be required to file a negative change statement to prove that they have carried out this review but not found that changes need to be made? We would caution against a need to create a further detailed paper trail that AIFM are required to submit on a regular basis.
In relation to paragraph 2, we would question whether regulators should take up the role of a "meta risk manager" (and try to make qualitative assessments of a potentially vast number of different policies), and propose that this requirement be deleted. Moreover, AIFM may be updating their risk management policies on a constant basis and this may lead to regulators receiving multiple filings from AIFM. We would suggest that paragraphs 1 and 3 be combined or that the duplication between these paragraphs be removed.

2.5.5 Measurement and management of risk (Box 28)

The use of the words "might" in sub-paragraph 1(a) and "anticipated" in sub-paragraph 3(e) appear to widen the compliance burden on AIFM and require unrealistic foresight on their part. We would propose that a standard that requires a reasonable expectation of being exposed to these risks be included.

It may not always be possible, in relation to sub-paragraph 1(b), to ensure compliance with limits (such as in time of market stress), and we would therefore propose that this wording be revised to reflect this.

The viability of the back-testing and stress testing referred to in sub-paragraphs 3(b) and (c) will be heavily strategy dependent, and there should at the very least be an acknowledgment that such testing should bear relevance to the underlying investment strategy of the AIF in question. At the very least, this should be linked to an appropriateness standard.

Finally, we believe it should be clearer that the principle of proportionality applies to sub-paragraph 3.

2.5.6 Risk limits (Box 29)

Overall, we strongly support the deletion of this box as it is unnecessarily prescriptive. We believe that an high level requirement to set appropriate risk limits in the AIFM's risk management policy should be sufficient, without further specifying whether these are quantitative or qualitative. Requiring quantitative limits to be set for all AIFs may indeed go against the whole idea of alternative investment management and lead to either nonsensical or irrelevant limits being set or to fund managers not being able to take advantage of certain market opportunities.

This is one of the areas where we believe the obligations go well beyond what is required today by MiFID and could also have some important unintended consequences from the point of view of systemic risk. Policies which either explicitly or implicitly hard-wire into regulation a behaviour which would encourage market participants to decrease exposures in an automatic way upon quantitative risk limits being breached risks introducing a strong element of pro-cyclicality into an industry which has been judged by many to provide a welcome and stabilising counter-cyclical influence on the markets.

Finally, we query whether the need to document a risk management approach and the supervision of risks may be self-defeating because the risk management function may become subservient to complying only with a stated written policy that may not be updated sufficiently quickly to include risks that become apparent within a very short period of time.

2.5.7 Functional and hierarchical separation of the risk management function (Box 30)

We support the broad policy of requiring the separation of portfolio and risk management staff unless the nature scale and complexity of the AIFM's business requires otherwise. We therefore strongly support the idea that as long as the AIFM is capable of maintaining adequate independence of the risk management function, full separation of the roles may not be required.

We have the following comments on Box 30:

- In relation to sub-paragraph 1(d), we understand that the criteria for a proportionality test regarding the requirement to establish a remuneration committee will be laid down in additional ESMA Guidelines in accordance with Article 13.2 AIFMD.

- In relation to sub-paragraph 1(e), it should be sufficient for this requirement to be fulfilled if there is a direct reporting line by the head of the risk management function to the governing body of the AIFM.

- Not permitting those who hold a risk management function to share in the performance of AIF may be difficult/impossible to achieve, given the comingling of fees within the AIFM to pay staff costs.

- We believe it should be clear that risk and operational risk management functions can be combined and, to the extent permissible under Level 1, that risk managers can share in bonuses linked to overall AIFM financial performance. The AIFM should be able to freely design its operations based on needs, technology, staff availability and resources to ensure that those operations are appropriate to that AIFM.

- There should be a small AIFM carve-out for sub-paragraph 3(e), notwithstanding the proportionality qualifier.

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

No additional safeguards are necessary.

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?

AIFM of smaller funds, highly automated funds, exotic funds and PE will have the most difficulty in demonstrating an independent risk management function. Competent authorities should have regard to policies that those AIFM have designed and that evidence a risk management function that is sufficiently robust given (i) the nature and size of the AIFM, (ii) the nature of the AIF and (iii) the disclosure that the AIF has made. If rules are fundamentally about 'disclosure', then these can be accommodated.

2.6 Possible implementing measures on liquidity management (section IV.V)

2.6.5 Summary

AIMA has certain concerns in relation to ESMA's proposals on liquidity management. In particular, we disagree with the definition of "special arrangements" and the inclusion of mechanisms such as gates which we regard as a prudent method for managers to ensure that redemptions can be met. This is described further below. We also believe that the requirements in relation to stress tests need to be tailored further.

2.6.2 Liquidity management definitions (Box 31)

We believe further consideration should be given to the inclusion of gates within provisions regarding the application of "special arrangements". There are compelling arguments that, rather than being a bar to liquidity within AIFs' gating mechanisms are in fact there to provide an aid to liquidity, by providing a mechanism whereby the liquidation of assets in the portfolio can be managed in a "orderly" fashion so as to avoid situations where genuine "special arrangements" (such as the utilisation of side pocket mechanisms or the application of suspension powers need to be applied). It is very often the case that gating provisions are included specifically so as to provide exposure to assets where liquidity is somewhat limited in a manner which ensures that no investor is disadvantaged by the actions of others when seeking to withdraw assets from the AIF. It would, therefore, be useful to move away from the preconception that the starting point for consideration of liquidity terms should be that all investors should be able to redeem all of their investments in the AIF at the same time on the same day with no impact on the price at which the redemption is effected.

2.7.2 Liquidity management policies and procedures (Box 32)

We have the following comments (using the numbering of the paragraphs in Box 32):

1. The references to "underlying obligations" to "counterparties, creditors and other parties" seem to be too broad. The Directive itself does not contemplate the AIFM being obliged to have regard to the interests of such parties and, moreover, doing so may potentially place the AIFM in a position where the interests of those parties conflict with its obligations to act in the best interests of the AIF or its investors. We would, therefore, recommend that these references are removed. We would also recommend changes to make it clearer that the AIFM is obliged to have regard to the *AIF's* obligations to its investors as regards redemptions, rather than implying that there is some direct relationship as between the AIFM and investors on this point.

3.(a) This paragraph should be modified, to clarify that liquidity considerations should not be regarded as overriding. Without modification, there is a risk that the relevant provisions are construed in such a manner that the assessment of liquidity is the primary consideration of the AIFM in determining the portfolio of the AIF. This could serve to prevent the AIFM from implementing investment transactions in accordance with the stated investment strategy and being in a position where it is, effectively, obliged to depart from fundamentally valid investment theses in circumstances where there are changes in liquidity which could be of a relatively short term nature in relation to a position which the AIFM has adopted in a particular investment.

3.(b) We would recommend deletion of this paragraph. It contemplates the AIFM as being privy to the basis on which investors may or may not exercise their investment rights, and, potentially, having to adjust the way in which the assets of the AIF are invested to have regard to these interests. This would seem to be inappropriate, given that the terms of redemption to which all investors are subject are a function of the offering documents and constitutional documents of the AIF. There is no apparent reason why it should be the responsibility of the AIFM to seek to "protect" one category of investors in the AIF from another who may be perceived as more or less likely to exercise those redemption rights.

3.(c) We would suggest deletion of this paragraph. As regards "conventional" hedge funds, the proposed language may impinge upon their ability to use certain highly-liquid underlying investments (such as overnight money market funds) where it will be impracticable for them to undertake the kind of reviews referred to in this paragraph. In relation to funds of hedge funds, this paragraph would serve the purpose of compelling a fund of hedge funds manager to procure favourable information rights from underlying funds in which it invests. The net result of this could be hugely prejudicial to the interests of other investors in those underlying funds who would not be privy to information regarding the liquidity of the assets afforded to fund of hedge fund managers. This does not seem to be consistent with the Directive's objectives of trying to achieve protection of investors in AIFs.

3.(d) We would suggest modification of this paragraph to enable more "generic" views on liquidity issues to be considered. This is particularly important for high frequency trading and systematically managed funds where liquidity parameters are a function not of individual investment decisions, but rather broadly defined considerations which are applied based on conventional market norms in the relevant instruments. As a broader point, for most strategies, the trading styles adopted by AIFM are unlikely to be consistent with a requirement that there is some sort of "liquidity check" on individual investment decisions before they are taken.

3.(e) We would suggest modification of this paragraph to make it clear that the AIFM shall only be required to adopt such policies and procedures to the extent that the AIF itself has failed to make adequate disclosures in respect of redemption policies in its own constitutional and offering documents.

3.(f) Should this provision not be limited to "special arrangements", rather than referring to "tools and arrangements"? Please also see our comments above regarding what should and should not properly be regarded as "special arrangements".

3.(g) We would suggest deletion of the proposed obligation that AIFM be obliged to deal with conflicts of interest as between different constituencies of investor in the AIF. As a practical proposition, it is almost impossible for the AIFM to identify such conflicts, other than in a superficial and generic fashion and, moreover, it is not necessarily within the AIFM's gift to take any steps whatsoever to mitigate or manage such conflicts (particularly in extreme and stressed market circumstances). We would point out that investors in most AIFs will already be subject to a degree of protection in respect of such issues, by virtue of the fiduciary obligations likely to be imposed on the board of directors (or equivalent) of the AIF itself, which should serve to protect the interests of different constituencies of investors in such circumstances. We are also unclear as to what the perceived "incentive" is for AIFM to invest in illiquid assets. We would suggest

that these provisions should also be deleted or that amendments be made to clarify what perceived risks ESMA believes need to be addressed by this element of the guidance.

3.(i) It is unclear what is anticipated as being a "escalation measure". ESMA should consider more detailed provisions regarding their concerns on this issue. Is it, for example, anticipated that such provisions would relate to advice to be given to the governing body of the AIF as the application of the tools available to manage liquidity issues to it in certain circumstances?

2.7.1 Liquidity management limits and stress tests (Box 33)

We have the following comments (using the numbering of the paragraphs in Box 33):

1. We would suggest that these provisions are softened somewhat. There has to be some balancing between the strict liquidity requirements and the ability of the AIFM to take views on positions in investments that assume a certain degree of stability within the asset base of the AIF. This issue will be particularly acute in relation to strategies involving fundamental analysis and long term views on particular opportunities.

2. These provisions should be qualified so that the obligation to apply stress tests is modified to have regard to the investment strategy of the AIF. For example, is it beneficial to the interests of investors to require a managed futures fund which trades exclusively in highly-liquid instruments to undertake such stress testing on more than an annual basis? Would it not be more appropriate to oblige only those AIFM who actively trade in illiquid investments only to conduct stress testing more frequently than annually?

3. It would not seem appropriate to require AIFM to "act in the best interests of investors" as regards the outcome of stress tests. It would be a more appropriate obligation to require periodic reports to the governing body of the AIF as regards the outcome of stress tests, so that they themselves can consider whether or not there is any need to, for example, propose alternative liquidity management tools in the AIF to investors or to instruct the AIFM to liquidate or otherwise shift emphasis in the portfolio of the AIF.

2.6.5 Alignment of investment strategy, liquidity profile and redemption policy (Box 34)

We do not have any comments in addition to our responses to the question below.

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?

We strongly disagree with a policy which deems the use of special arrangements as exceptional or as a failure of the liquidity management process. These tools are inherent liquidity management tools that have allowed the industry to operate even under conditions of severe market stress. Discouraging the use of special arrangements by describing those as a failure of liquidity management will inadvertently lead to the decreased use of these arrangements and a potential deepening of pro-cyclicality in the markets. Please also note our earlier comments regarding the differences between gates and other liquidity management tools. We submit that a more proper view of the purpose of gating mechanisms is actually to enhance the liquidity available to investors in the AIF and to diminish the likelihood of "special arrangements" being applied in relation to redemptions.

Side pockets are a somewhat different mechanism and there are certain investment strategies where the use of side pockets is fundamental (for example "hybrid" funds which invest actively and significantly in both traded and private assets, where a side pocket mechanism is used as a means of ensuring that there is a close alignment between liquidity in the portfolio and the liquidity available to investors).

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?

ESMA's proposed approach of itself does not give rise to concerns about the impact upon fair treatment of investors. However, there does need to be some recognition of the fact that there may be circumstances in which the interests of investors are not sufficiently aligned that it is possible to procure fair treatment of the investor base overall. Such circumstances are particularly well illustrated by some of the experiences of AIF during the crisis period of 2008 and 2009 where some categories of investor (for example, funds of funds) were concerned to procure liquidity in their investments "at any cost", in some cases to the detriment of other categories of investor (such a pension funds) who were able and willing to take a longer term view of the investment in the relevant AIF and who were, therefore, able to withstand periods of volatility in the value of their investments in the AIF. The proposed advice should be mindful of this fact and should acknowledge that there will be circumstances in which it will not be possible to achieve fair treatment of investors because of the divergent interests of those who wish to remain invested in the AIF and those who may wish to redeem.

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

While the underlying principle of ESMA's proposed advice is not, of itself objectionable. The need to align the investment strategy, the liquidity profile and the redemption policy of the AIF is something of which most AIFM are acutely aware and, particularly in respect of institutional investors, is increasingly an issue on which investors undertake detailed due diligence so that they themselves can ascertain the extent to which these elements have been properly reconciled in the construction of the product. However, we would be somewhat concerned that an over-emphasis on regulatory advice on these issues (which are quite often subjective in nature) could have a negative impact on the protection of the interests of investors by discouraging them from conducting their own due diligence, in reliance on the regulatory obligations imposed on AIFM. This would not seem to be a desirable outcome in all the circumstances.

2.7 Possible implementing measures on investments in securitisation positions (section IV.VI)

2.7.1 Summary

Our main concern in relation to this section is to equate the retention requirements in AIFMD with those in Article 122a of the CRD so that a common, industry wide requirement is applied, rather than having different requirements across the industry. Furthermore, we are concerned that appropriate grandfathering provisions related to existing securitisations may be missing. Paragraphs 1 to 7 of Article 122a of the CRD2 text introduce the basic 5% retention requirement as well as a host of qualitative requirements related to the holding and monitoring of investments in securitisation positions. Article 122a(8) then states that paragraphs 1 to 7 apply only to new securitisations issued on or after 1 January 2011. Although the level 1 text specifies that the delegated acts should specify the conditions which need to be met by the relevant parties in order for the AIFM to invest in the securitisations which were issued after 1 January 2011, the text lacks a clear provision, similar to the CRD provision which would specify that all of the requirements, including the qualitative requirements which are mentioned in paragraph b) of Article 13 of the AIFMD are to be applied only to securitisations issued after 1 January 2011.

Requirements for retained interest (Box 35)

In our view, the following key issues need to be addressed by the ESMA advice:

ESMA should specify that these provisions are intended as or maximum harmonisation provisions. For example, Member States should not be able to impose additional, e.g., 10% retention requirements. In our view this should be a maximum harmonisation provision such that 5% relation is standardised across the EU.

Box 35, paragraph 1 and in several other places the requirements are stated to apply to persons which have exposure to "repackaged loans". Whilst paragraph 9 suggests that ""tradable securities and other financial instruments based on repackaged loans" is another way to refer to a "securitisation" (and Box 35 paragraph 1 also refers to the documentation governing the securitisation), the Level 1 text and Level 2 draft text does not specifically include the concept of tranching, which is implicit in the Article 122a CRD provisions as the definition of securitisation under CRD is predicated on there being tranched exposures. Given its significance, the concept of tranching should be specifically included in the AIFMD provisions, since otherwise the AIFMD text is potentially wider than the CRD text because it could cover repackaged loan structures which are not subject to tranching (unlike the CRD 122a provisions). Many repackagings take the form of just one tranche and thus arguably could be covered by the AIFMD provisions, but not the CRD. We doubt this is the policy intention and see no policy justification for a different application of the 5% retention provisions. We would encourage ESMA to clarify that the scope of the AIFMD requirements is not intended to be more extensive than the CRD. In our view it is important that there is consistency in relation to the application of this regulatory requirement across the whole industry.

More generally, the terms "originator, sponsor or original lender" should be defined. These terms are defined under the CRD but seemingly not under AIFMD. Given the difficulties with identifying and structuring the most appropriate person to retain interests in the CLO context (and see below), the AIFMD Level 2 text presents an opportunity to seek to address some of the difficulties and questions on this point. One possibility would be to specify that, for the purposes of the AIFMD provisions, a "sponsor" includes a CLO manager.

Box 35, paragraph 1. This requires the 5% economic interest to be determined at origination "and if later, at the date of assumption" and that it should be maintained on an ongoing basis. The CRD simply requires that net economic interest is measured at origination and shall be maintained on an ongoing basis. It is unclear what is required by the addition of the extra words in the draft Level 2 text (i.e., "and if later at the date of assumption...") and we consider that they should be removed. To the extent that they impose additional requirements on the sponsor etc beyond ensuring that the documentation governing the securitisation indicates that the 5% interest is held and will be maintained, the AIFMD text imposes additional burdens to those imposed on banks under CRD. As stated above, the AIFMD should in our view be brought into line with the CRD.

Box 35, paragraph 2. It should be made clear at the end of paragraph 2 that if the "other entity" retains 5%, that can satisfy the retention requirements and an AIFM can rely on that. This is particularly important in the context of CLOs and we would suggest that Box 25, paragraph 2 is also more specifically linked to paragraph 12, which refers to the CEBS guidelines in relation to CLOs.

2.7.2 Requirements for sponsors and originator credit institutions (Box 36)

Box 36. These requirements do not arise in the CRD Article 122a context - i.e., investing banks do not need to satisfy themselves of these matters relating to the sponsors, originators and lenders when they invest in a securitisation. Rather, these requirements apply to credit institutions more generally when granting loans. It is therefore inappropriate to expect AIFMD to satisfy themselves in relation to these matters when investing banks do not need to do the same under CRD.

Furthermore, applying the Box 36 criteria to any party other than an original lender is inappropriate in the securitisation context. How could these requirements be met by a sponsor or originator SPV which has purchased the assets to be securitised, for example? And how might an investing party be expected to satisfy itself in relation to, say, a CLO where the underlying portfolio of loans was granted by several

different banks? A similar point arises under paragraph 22 - the credit policy is likely to be relevant only to the original lender.

Box 36. It is in any event impracticable for the AIFM to "ensure that" the originator, sponsor and lender meets the requirements specified - it is not in a position to do this. The CRD requirement "take steps to be reasonably satisfied" may be more appropriate. This also applies to paragraph 22 and other requirements in the draft text for the AIFM "to ensure" certain matters.

Paragraphs 22 - see comments above about "ensuring". In any event, where there is a public listing, this information can be deemed to be given in the offering circular.

Paragraph 23 - this is impractical. An originator is highly unlikely to covenant as contemplated. Indeed, it may be prevented from giving this (subjective) information for legal reasons in any event. As a drafting point, we assume the references in paragraph 23 to Box 2, paragraph 1 should be to Box 36, paragraph 1.

Box 39. This is consistent with Article 122a.5. However, we question how feasible it will be for smaller AIF to comply with this requirement.

2.7.3 Requirements for stress tests (Box 40)

We do not have any comments on the text in this Box.

2.7.4 Requirements for formal policies, procedures and reporting (Box 41)

Box 41. There should be clarity on what, if any, sanctions for failure to comply may exist.

2.7.5 Introduction of new underlying exposures to existing securitisations (Box 42)

Box 42. In any event, we do not think it is appropriate to follow the approach taken under CRD in the AIFMD in relation to 2014. To the extent that securitisations fall within the provisions from 2014, it is likely to be difficult (or in some cases may be impossible) to find an appropriate person to retain the 5% interest. This is expected to cause problems for banks and for the success of extant deals as investors may be forced to sell, causing liquidity problems and write downs in portfolios. By imposing the 2014 CRD type requirements on aAIF, this problem will only be exacerbated. It would be preferable, we believe, not to impose the 2014 provisions on AIF so that AIF would not be forced to sell after the 2014 date, so that even if banks are forced to sell at that time, AIF will still be able to hold securitisations (and help to maintain price stability and liquidity) should they wish to do so.

2.8 Possible implementing measures on organisational requirements (section IV.VII.)

2.8.1. Summary

We broadly support ESMA's approach, albeit with a few detailed suggested changes. In particular we commend proposals to bring requirements in line with those applicable under MiFID.

2.8.2. General requirements on procedures and organisation (Box 44)

In common with comments made in response to various other sections of the consultation, our main concern with regards to the implementing measures relating to Article 18 has been to ensure that where existing rules apply to AIFM that are authorised prior to the implementation of the Directive, the Directive and implementing rules do not have the effect of duplicating or otherwise changing existing rules. We therefore support the approach of utilising existing regulatory requirements, particularly those derived from MiFID, rather than creating any duplicative or overlapping requirements.

We also strongly support the approach that in applying the rules AIFM should take into account the nature, scale and complexity of their business and the nature and range of services and activities undertaken in the course of that business.

We believe it should be made clear that AIFM should do so in applying all the implementing rules relating to general requirements on procedures and organisation in Box 44, not just those at paragraph 1.

We also believe the implementing measures should state expressly that it is permissible for a smaller AIFM to have less extensive human and technical resources than may be required by a larger AIFM.

2.8.3. Resources (Box 45)

We broadly support ESMA's approach. However, we believe that the implementing measures should, with reference to paragraph 3, state expressly that it is permissible for a smaller AIFM to have less extensive human resources than may be required by a larger AIFM.

2.8.4. Electronic data processing (Box 46)

We broadly support ESMA's approach. However, with regards to the requirement for "appropriate arrangements" at paragraph 1, we believe that the implementing measures should state expressly that it is permissible for a smaller or less complex AIFM to have less extensive technical resources than may be required by a larger or more complex AIFM.

2.8.5. Accounting procedures (Box 47)

The text seems to imply that the AIFM would maintain the accounts, which is incorrect. It appears that a minor typographical error has been carried from the UCITS Level 2 into the second sentence of paragraph 1, where "time" should read "times".

2.8.6. Control by senior management and supervisory function (Box 48)

The text should be tailored to provide for other legal forms, such as limited liability partnerships, where there are no directors but partners. We also submit that the reference in paragraph 12 of the Explanatory Text to non-executive directors, should be deleted. Non-executive directors, are precisely non-executive and should therefore not have this role. We assume the inclusion of "if any" is intended, in our view appropriately, to acknowledge that it is not a universal expectation that an AIFM will have a supervisory function (as defined in paragraph 12 of the explanatory text)?

We believe that paragraph 2(b) is inappropriate in the context of the AIFMD as it does not acknowledge the extent to which the investment strategies, or policies, of a managed AIF may be set not by the manager but at the level of the AIF by virtue of its fund rules, the instruments of incorporation, the prospectus or offering documents rather than by the AIFM. We therefore think the emphasis of this paragraph should be on the responsibility of senior management for overseeing the "implementation" of the investment strategy or policy. We therefore suggest that paragraph 2(b) be deleted or, alternatively, be amended to read as follows:

> *(a) oversees the implementation of the investment strategies and policies for each managed AIF;*

2.8.7. Permanent compliance function (Box 49)

We agree with ESMA that details of the technical and personnel organisation of the compliance function should be calibrated to the nature, scale and complexity of the AIFM's business and the nature and range of its services and activities.

We note from the explanatory text ESMA's belief that while, as a general rule, the AIFM should establish a compliance function in the form of an independent compliance unit, the AIFM should not be required to establish an independent compliance unit if this would be disproportionate due to the size of the AIFM or the nature, scale and complexity of the AIFM's business. We believe that this distinction between "a permanent and effective compliance function which operates independently" on one hand and "an independent compliance unit" on the other, is not clear from the implementing measures unless read together with ESMA's explanatory text. We therefore suggest that the last paragraph of Box 49 be amended to reflect ESMA explanatory text so as to read as follows:

"However, an AIFM should not be required to establish an independent compliance unit if this would be disproportionate due to the size of the AIFM or the nature, scale and complexity of the AIFM's business. For example, appointing a separate compliance officer may be disproportionate for AIFM the business of which is of small size and entails a lower risk to constitute conflicts of interest.

Nor should an AIFM be required to comply with point (c) or point (d) of the first sub-paragraph where it is able to demonstrate that in view of the nature, scale and complexity of its business, and the nature and range of its services and activities, that requirement is not proportionate and that its compliance function continues to be effective."

2.8.8. Permanent internal audit function (Box 50)

We broadly support ESMA's approach. We note from the explanatory text ESMA's belief that an AIFM should establish and maintain an internal audit function separate and independent from other functions and activities of the AIFM but that in case this separation and independence should be disproportionate to the scale and complexity of the AIFM's business, the responsibilities of the internal audit function may be carried out by another business unit of the AIFM.

We believe the possibility of having an internal audit function which is not separate and independent but, instead, carried out by another business unit of the AIFM may not be sufficiently clear from the implementing measures unless read together with ESMA's explanatory text. We therefore suggest that the first paragraph of Box 50 be amended to reflect ESMA explanatory text so as to read as follows:

"AIFM should, where appropriate and proportionate in view of the nature, scale and complexity of their business and the nature and range of collective portfolio management activities undertaken in the course of that business, establish and maintain an internal audit function which is separate and independent from the other functions and activities of the AIFM.

Where such separation and independence of the audit function is disproportionate to the scale and complexity of the AIFM's business, the responsibilities of the function may be carried out by another business unit of the AIFM."

2.8.9. Personal transactions (Box 51)

We broadly support ESMA's approach. However, we note that the final sentence of paragraph 2 (which requires AIFM to ensure that third parties maintain records of personal transactions and provide that information on request) goes significantly beyond Article 18 of the Directive, which only requires an AIFM to have "rules for personal transactions by its employees".

We do not believe it is either reasonable or workable in practice to require an AIFM to "ensure" that actions are carried out by a third party. Moreover, relevant third parties are likely to be directly subject to rules relating to personal transactions in their own right. Our preference is therefore for this sentence to be deleted. Alternatively it should be amended by the insertion of the words "use reasonable endeavours", so as to read as follows:

"For the purposes of point (b) of the first subparagraph, where certain activities are performed by third parties, the AIFM shall use reasonable endeavours to ensure that the entity performing the activity maintains a record of personal transactions entered into by any relevant person covered by paragraph 1 and provides that information to the AIFM promptly on request."

2.8.10. Recording of portfolio transactions (Box 52)

This appears to be a sensible adaptation of the UCITS Directive requirement.

2.8.11. Recording of subscription and redemption orders (Box 53)

We believe that the recording of subscription and redemption orders should only required in cases where the AIFM is the recipient of these. Commonly, subscription and redemption orders are sent to directly to the administrator who will perform the anti-money laundering checks. We think that paragraph 2(i) should, in relation to committed capital, be referring to drawn and undrawn commitments and accordingly the words "and unpaid" should be deleted.

2.8.12. Recordkeeping requirements (Box 54)

This appears to be a sensible adaptation of the UCITS Directive requirement.

2.8.13. Complaints handling

We do not have any comments in addition to our responses to the question below.

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?

No. We do not believe any requirement for complaints handling should be included. We agree with ESMA that since the AIFMD regulates the marketing to professional investors and not to retail investors, an AIFM should not be required to establish and implement procedures for the handling of complaints.

For the avoidance of doubt, we would make the point that investors in an AIF managed by an AIFM are not, as such, clients of the AIFM.

2.9 Possible implementing measures on valuation (section IV.VIII)

2.9.1 Summary

We support ESMA's approach in a number of areas, albeit with a few detailed suggested changes. We have a material policy concern with ESMA's proposed advice in Paragraph 24 of the Explanatory Text and suggest an alternative approach below. We are also concerned that no further clarification has been provided as to what an AIFM must do to prove functional independence for the purpose of Article 19(4)(b).

2.9.2 Policies and procedures for the valuation of the assets of the AIF (Box 55)

We generally welcome the approach taken in Box 55.

Paragraph 4 in Box 55 refers to a process for information being provided to an external valuer by the AIFM "to ensure that all necessary information required for the purpose of performing the valuation task is provided". This should however only refer to all necessary information which is in the possession of the AIFM since it otherwise implies that the AIFM must provide all information which is necessary for this purpose even that which the AIFM does not possess. One of the reasons for appointing an external valuer may be because of its superior knowledge or expertise in valuation matters and it may well be able to provide additional information which is necessary for this purpose.

Paragraph 11 of the Explanatory Text to Box 55 states that the external valuer may be appointed by the AIF "where the legal form of the AIF permits an internal management". We think this should only be the case where there is actual internal management, not where the legal form permits internal management but it is not actually so provided. Where an external AIFM is appointed by the AIF, the AIFM is responsible for valuation matters under the Directive and the AIFM must therefore appoint any external valuer.

2.9.3 Models used to value assets (Box 56)

It is unclear what is required by the reference in Paragraph 2 of Box 56 to a model being "validated" by a third party. Further explanation and clarity is required in order for this to be a workable provision. When and under what circumstances is such a model "validated" – what is/are the test(s)? We urge ESMA to be more specific and clear in this regard. Also, some explanation of what will constitute a "model" for this purpose would be helpful.

2.9.4 Consistent application of the valuation methodologies (Box 57)

It will not always be feasible to apply the same valuation policies and procedures across all AIF having the same AIFM. Accordingly, it would be helpful and appropriate if the reference to "taking into account

the investment strategy, the type of assets and, if applicable, the existence of different external valuers" could be amended to make it clear that such policies and procedures do not have to be applied consistently across all AIF having the same AIFM.

2.9.5 Periodic review of the appropriateness of the policies and procedures including the valuation methodologies (Box 58)

We support the comments in Box 58 and the associated Explanatory Text.

2.9.6 Review of individual values (Box 59)

The statement in paragraph 18 of the Explanatory Text that "If the valuation of an asset refers only to such a price the valuation of the asset may be inappropriate." (emphasis added) is unclear as to whether ESMA is seeking to prevent individual assets being valued on this basis. Paragraph 19 is also poorly worded – are some words missing from the first sentence?

2.9.7 Calculation of net asset value per unit or share (Box 60)

The statement in paragraph 24 of the Explanatory Text that a third party which calculates the net asset value of an AIF based on values obtained from the AIFM, pricing sources (e.g., exchange prices for securities traded on a liquid securities market) or values obtained from an external valuer is not an external valuer for Article 19 purposes gives rise to considerable uncertainty and should be further clarified. Indeed, it is difficult to imagine how the text of paragraph 24 is compatible with a number of provisions of the Level 1 text.

Legal analysis

Article 19 of the Level 1 text clearly distinguishes between the valuation of assets in paragraph 1 and the calculation of the net asset value in paragraph 3. However, no distinction is made between these two functions in the rest of Article 19 which AIMA interprets to mean that the requirements apply in the same way to both of these functions. Article 19(5)(b) specifically states that when an external valuer performs a valuation function, it must "provide sufficient professional guarantees to be able to perform effectively ***the relevant valuation function in accordance with paragraphs 1, 2 and 3***.

Furthermore, paragraph 19(10) refers to the AIFM's liability for the valuation of AIF assets, the calculation of the net asset value and the publication of that net asset value. It is clear that the valuation function encompasses both the functions of valuation of assets and calculation of net asset value also for the purposes of the liability provisions and that a third party that performs either one of these functions, or both, should be regarded as the external valuer. **However, it is our view that the Article does not presuppose that an external valuer must perform both valuation functions and we would wish to leave the freedom to delegate one or both of the valuation functions to the negotiation between the fund manager or the fund governing body and the administrator. Finally, we believe that the text clearly allows for more than one external valuer to be appointed.**

Investor protection considerations

To the extent that ESMA's intention is, despite the Level 1 text, to fully exclude the calculation of net asset value from constituting the valuation function, we would highlight that this may have a number of unwelcome consequences which will not encourage the practice of hedge fund managers to use the services of third party fund administrators.

The net asset value per share or unit figure (and its calculation) is the single most important figure in any hedge fund since investors are only entitled to subscribe and redeem at that price and fees are paid to the investment manager and administrator based on that figure. So far as investors are concerned, the net asset value per share or unit (and the process of its calculation) is the "value" of their investment and the administrator, in calculating it, is the "valuer". **In practice, when errors occur they are more prevalent in net asset value per share or unit calculation process than they are in the valuation of individual assets. Most errors are process or mathematical errors by administrators. It is therefore very important for investors that the protections conferred by the Directive apply equally to net asset value calculation when performed by an administrator as they do to the valuation of assets.**

Hedge funds commonly delegate one or both of the valuation functions to a third party administrator, which is particularly appropriate considering that the hedge fund managers' remuneration is based directly on the net asset value. Where an AIF invests in liquid securities, there is no "valuing" of the individual assets in the strict sense of the word. In reality the administrator may compare data from different sources (e.g. Bloomberg and Reuters or quotes from brokers) to make sure there are no discrepancies, before calculating total assets and, importantly, total liabilities to arrive at a net asset value. Still whether an AIF trades in liquid or illiquid securities should not be the decisive factor in whether a third party should be classified as an external valuer or not. We understand that processes may vary for other parts of the alternative industry, such as the private equity sector or other sectors where it may be common for the manager to be the source of the prices which are taken up by the administrator.

The key policy driver here should be to encourage the continued practice of hedge fund managers in the EU to outsource administrative functions, including the calculation of net asset value, to third party fund administrators as this provides a key investor protection measure and reduces conflicts of interest which the AIFM would otherwise face in carrying out those functions. The impact of paragraph 24 of the Explanatory text could be that the vast majority of third party, independent hedge fund administrators will not qualify as external valuers in relation to the calculation of net asset value since most will only in this regard incorporate prices from other sources (particularly for strategies based on liquid securities). There are several unwelcome consequences of the approach suggested by paragraph 24 of the Explanatory Text:

under Article 19(5)(a) there is then no requirement on the AIFM to demonstrate that the administrator as external valuer is subject to mandatory professional registration; and

under Article 19(5)(b) there is then no requirement for the administrator to provide sufficient professional guarantees;

under Article 19(6) the administrator is not prevented from delegating its role to a third party; and

the provisions of Article 19(10) would not be applicable to make the administrator liable to the AIFM for any losses suffered as a result of the administrator's negligence or intentional failure to perform.

The further paradoxical consequence of paragraph 24 of the ESMA explanatory text is that if the fund manager actually does not perform any valuation of individual assets (as these are, for example, liquid publicly traded securities) and delegates the calculation of the NAV to an administrator who is not in scope of Article 19, it becomes difficult to understand what residual responsabilities remain for the manager. The conclusion would be that in such instance, the AIFM would not need to comply with the provisions of Article 19 since there would be no activity which would properly fall under the scope of this Article.

Such outcomes could be clearly detrimental to investors' interests.
We also note that no further clarification has been provided as to what an AIFM must do to prove such functional independence. This is also a key area of concern.

Drafting note: should the reference to "issue or subscription" in paragraph 1 in Box 60 refer instead to "subscription or redemption" as does paragraph 21 of the Explanatory Text?

2.9.8 Professional guarantees (Box 61)

We would prefer to see own funds and/or PII cover provided by an external valuer. We not that ESMA proposes to require only a written statement of experience to be provided and that this, by itself, would not be a guarantee of anything.

2.9.9 Frequency of valuation carried out by open-ended funds (Box 62)

We generally support the comments made here.

2.10 Possible implementing measures on delegation (section IV.IX)

2.10.1 Summary

AIMA supports the position taken by ESMA that the delegation requirements should not apply to every small task that is delegated and we think this could be usefully clarified. We also have some comments in relation to assessing whether a delegate has sufficient experience and is of sufficiently good repute where we believe the requirements needs to be amended slightly.

2.10.2 Delegation (Box 63)

We support the principle that "it is not proportionate to require the AIFM to comply with requirements in Article 20 for each and every small task that is undertaken by a third party". Accordingly, we believe that paragraph 1 of Box 63 should be amended by inserting "(other than supporting tasks)" after "functions" in the last line. We also agree that it is essential to be clear as to what 'supporting tasks' means.

We agree with ESMA that the items set out in paragraph 3(a) and (b) should be considered supporting tasks. In addition, in accordance with Recital 31 of the Directive, the delegation provisions of Article 20 of the Directive should apply only to the "management functions set out in Annex I" to the Directive (i.e. to "portfolio management" and "risk management" as set out in paragraphs 1(a) and 1(b) of Annex I). We therefore believe that additional text should be added to Box 63 clarifying that (without prejudice to Article 19 of the Directive which deals specifically with valuation) all of the functions set out in paragraph 2 of Annex I constitute "supporting tasks" to which the provisions of Article 20 of the Directive do not apply.

Furthermore, we believe it would be helpful to clarify that the provisions of Article 20 of the Directive apply only to tasks and functions for which the AIFM (whether pursuant to its contract with the AIF or pursuant to the AIF's constitution) is responsible. Article 20 of the Directive should not apply where the AIF has directly appointed someone other than the AIFM to perform a particular task.

2.10.3 General principles (Box 64)

There appears to be an overlap between paragraph 1(e) of Box 64 and the content of Box 73 relating to whether or not the AIFM has become a "letter box" entity. We would suggest either deleting the first sentence of paragraph 1(e) or cross-referring to the provisions relating to "letter-box entities".

2.10.4 Objective reasons (Box 65)

We do not have any comments in addition to our responses to the question below.

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

Option 1 is preferable. It is important to align AIFMD with the UCITS Directive in this respect as it is possible that existing non-MiFID management companies would also become AIFMs, if they can meet the relevant conditions. Moreover, the term "efficient conduct" is broad enough to factor in the itemised reasons set out in Option 2.

It must be made clear what "entire delegation structure" means**.** Is this on a per AIF basis or does the structure need to be justified at the AIFM level? We would suggest a per AIF basis, as the reasons for delegation may differ between AIFs. This seems to be consistent with paragraph 19 of the explanatory text.

2.10.5 Sufficient resources and experience and sufficiently good repute of the delegate (Box 66)

In paragraph 3 we would delete the reference to "theoretical knowledge" as its meaning is unclear (and if it is referring to academic expertise, this seems unlikely to be the justification for any delegation by an AIFM)**.** In our view, the sentence should read: "… the delegate should be considered to have

sufficient experience if it has appropriate practical experience in the relevant functions". In our view this goes further than what is required in MiFID and UCITS.

As currently drafted, paragraph 4 appears to place an absolute prohibition on appointing any delegate where any person who effectively conducts the business of the delegate has been the subject of any criminal, judicial or administrative proceedings or sanctions, however minor (and including road traffic offences) and, at least in the case of judicial proceedings, regardless of the outcome. Paragraph 4 should therefore be reworded such that in assessing whether the persons who effectively conduct the business of the delegate are of sufficiently good repute, the AIFM should be required only **to take account** of any negative records, including the nature and seriousness of the relevant criminal offences, judicial proceedings or administrative sanctions and their relevance to the delegated tasks.

Paragraph 29 of the explanatory text should be translated into Level 2 text, although as the Directive and paragraph 4 of Box 66 refer to the good repute of the persons who effectively conduct the business of the delegate, rather than to the good repute of the delegate itself, it would be helpful to clarify that if the delegate is established in the EU and authorised for the purposes of the delegated tasks, the requirement for the delegate's personnel to be of sufficiently good repute shall be deemed to have been satisfied.

2.10.6 Criteria to be taken into account when considering whether a delegation/ sub-delegation would result in a material conflict of interest with the AIFM or the investors of the AIF; and for ensuring that portfolio or risk management tasks haven been functionally and hierarchically separated from any other potentially conflicting tasks within the delegate/ sub-delegate; and that potential conflicts of interest are properly identified, managed, monitored an disclosed to the investors of the AIF (Box 71)

It is important to clarify that references to investors in an AIF are references to such investors **in their capacity** as investors in the AIF.

It would we believe be helpful to clarify what is meant by "controlling tasks" and "operating tasks". Could the examples in paragraph 43 of the explanatory text be used?

We agree with the proportional approach outlined in paragraph 44 of the explanatory text. However, it is unclear how this concept of proportionality is to be applied in the context of what appear to be four absolute requirements (those set out in sub-paragraphs 2(a) to 2(d) inclusive). Should paragraph 2 of Box 71 state that where conditions (a) to (d) are met, the portfolio or risk management tasks will be considered functionally and hierarchically separate, but that a proportionate approach is to be taken to determining whether in any other circumstances such tasks are sufficiently functionally and hierarchically separate.

2.10.7 Form and content of notification under Article 20(4)(b) of the AIFMD (Box 72)

In respect of delegated tasks, we would suggest that a brief outline, rather than a comprehensive list, should suffice. To introduce certainty to the process, we suggest a time frame for submission be introduced.

2.10.8 Letter-box entity (Box 73)

In relation to the paragraph 2, we anticipate that a power contained in the AIF's constitution or in a contract between the AIFM and its delegate will suffice to satisfy this condition. It would be helpful to clarify this in the Level 2 text accordingly.

3 Depositaries (section V)

3.1 Introduction

AIMA would like to underscore the legal and economic complexities associated with designing an appropriate and robust regime governing the operation of AIFM depositaries. In this respect, the draft advice produced by ESMA is very impressive, taking into account a number of technically difficult considerations. We welcome a number of proposals made by ESMA in this area and believe that, with some adjustments, these proposals could form the basis of a feasible depositary regime.

However, we are concerned that under some inexplicably narrow interpretations of the directive as regards depositary liability over actions of unaffiliated sub custodians, along with a choice of some of the more extreme operational options proposed, the depositary regime could end up being not only wholly unworkable but also potentially dangerous by greatly increasing systemic risk.

AIMA carried out a study in order to determine the potential impacts of the various options proposed in the ESMA draft advice. The basic findings can be summarised below while the detailed study is attached in the Annex.

Under the 'quasi' strict liability regime as it is proposed by ESMA's Consultation Paper, the industry could face increased costs at least **4-to-5 times greater than today**.

- Potential anticipated total costs to the industry under the implementing measures proposed could be **at least $6bn** or more under severe liability provisions. This uplift takes into consideration both fixed and variable cost charges but the largest proportion is expected to result from the liability related provisions.
- Prospective depositaries expect that they will have to pass on a considerable percentage of the burden of their increased liability and resulting costs to their clients (AIFs); funds having to pay greater service charges for doing business will see an impact on their Total Expense Ratios which will, unavoidably, be borne by investors in the fund.
- Mid-sized depositaries/sub-custodians could make a decision to exit certain markets/certain services, concentrating the number of remaining service providers to a smaller number and less choice for funds.
- Managers indicate that the unintended consequences also lead to increased costs for the fund as they would have to pass on the costs from their Depositary. This in turn, would result in more expensive products in terms of fees (and potentially lower performance) for investors in Europe.

If such extreme costs were to materialise as a result of a Commission policy, 75% of the managers we surveyed indicated they would either relocate their funds or even their entire business to a different domicile (outside EU) or enter arrangements which allow them not to hold the cash assets in custody (essentially using synthetic solutions).

3.2 Appointment of a depositary (section V.I)

3.2.1 Summary

- We agree with ESMA's proposal not to develop a model agreement. This is not required by the Level 1 text and would be unnecessarily prescriptive and lacking in flexibility.
- Box 74 should be amended to allow for a greater degree of flexibility – some provisions may be better set out in separate documents (such as service level agreements).
- As regards paragraph 3 of Box 74:
  - The reference to the depositary's liability should be consistent with what the Level 1 text says; and
  - The reference to the "objective reasons" for a contractual discharge should be consistent with the approach adopted in relation to Box 92. AIMA strongly supports Option 2 in Box 92.

3.2.2 Particulars to be included in the written agreement evidencing the appointment of a single depositary and regulating the flow of information deemed necessary to allow the depositary to perform its functions pursuant to Article 21 (2) of the AIFMD (Box 74)

We fully support ESMA's proposal not to recommend developing a model agreement for the appointment of the depositary.

Background

As we had previously responded to ESMA, we do not think there is merit in ESMA preparing a draft model agreement evidencing the appointment of a depositary pursuant to Article 21. The Directive does not require a model agreement: it simply requires that there be an agreement in writing.

The population of AIF subject to the Directive is extremely broad, with a range of structures and investment strategies represented. It seems to us highly unlikely that any model agreement could properly take account of the immense variation of AIF, the asset classes in respect of which they are invested and the differing property laws of the jurisdictions in which those assets are held.

Any model agreement would also need to be capable of being interpreted in accordance with a variety of local laws on a consistent basis. The different legal structures – both within the EU and outside – mean that this is an unrealistic objective which would inevitably not be achieved.

There is further considerable risk in seeking to be prescriptive in this area. A prescriptive model agreement could undermine the freedom (and negotiating strength) of AIF to determine the terms on which they wish to appoint a depositary. It could also potentially restrict depositary's ability to respond to relevant market, legal and regulatory developments.

In our view, any model agreement could not (and should not) meaningfully go beyond the matters suggested in Box 74, subject to our suggested amendments to the text in Box 74 set out below. In our view there is little purpose in seeking harmonisation via a model agreement, where only the most basic elements of the agreement can in practice be harmonised and even then at the risk of uneven interpretation of those provisions across jurisdictions.

Currently AIFs do not have depositaries within the meaning of the Directive. While some AIFs have custodians, the extent of the role is in some respects different. Once the Directive is in force the appointment process is likely to differ depending on the type of AIF. The distinction is therefore less likely to be drawn between a UCITS and an AIF in terms of process – it is more likely to be drawn depending, for example, on whether it is a real estate, private equity, or hedge fund (and, in the case of the hedge fund, processes may vary further depending on the fund investment strategy).

Ultimately, any centrally designed process may have costs and there is likely to be little benefit in it. Each depositary must, taking full account of the requirements, design a process which it is satisfied assists it to undertake its role and manage its risk.

Suggested amendments to Box 74 text

We agree, in broad terms, with the items ESMA has proposed to be required in the contract appointing the depositary. However, ESMA's proposals would seem to set a standard higher than that currently provided for UCITS in the UCITS Implementing Directive 2010/43/EC. Specifically, the matters covered in Articles 30 to 33 of the UCITS Implementing Directive are addressed in ESMA's proposals, together with a number of additional items.

Since it will be vital to ensure the requirements are properly tailored to the professional investor base of AIF, we suggest below a number of areas in which greater flexibility is appropriate in an AIF context:

- There should be greater flexibility for matters to be set out in separate documents (such as service level agreements). In particular, we see no reason why the following detailed matters need to be specifically set out in the agreement appointing the depositary:
    - the procedures to be adopted for each type of asset which may be entrusted to the depositary (paragraph 1);
    - the means and procedures by which the depositary will have access to information, and the process for receiving information from third parties (paragraph 7);
    - information regarding the sale, subscription, redemption etc of AIF units or shares (paragraph 10);
    - information regarding anti-money laundering and counter-terrorist financing obligations (paragraph 12); and
    - information on cash accounts opened in the name of the AIF/AIFM (paragraph 13).
- Rather, the agreement appointing the depositary could require that all such information and/or procedures must be agreed between the parties (or, where appropriate, provided by notice) but the detail may be documented elsewhere. This would make entering into the initial appointment, and subsequent variations of the relevant information and/or procedures, less time consuming and burdensome.
- We assume paragraph 2 requires a list of the types of assets which may fall within the depositary's function (rather than some wider description of those asset types).
- Paragraph 7 should not, indirectly, impose an obligation on the AIFM to "ensure" the depositary has access to information. This will not always be within the control of the AIFM, and (indeed) this wording goes further than that currently used in Article 30(d) of the UCITS Implementing Directive.
- The obligation under paragraph 11 should be to provide details of the parties' delegates at the outset and when changes occur thereafter (notwithstanding that "on a regular basis" is the formula used in the UCITS Implementing Directive).
- AIMA considers that the agreement should include an obligation for the depositary to require its delegates, as far as is practicable, to comply with the segregation criteria set out in Box 89 (please see our response on this topic).
- In relation to paragraph 3, please see our comments below in relation to the depositary's liability regime. In line with those comments, we are particularly concerned that paragraph 3 should not be taken to imply that the depositary is strictly liable for the acts or omissions of its (unaffiliated) sub-custodian unless there is a discharge of liability under Article 21(13) or (14). In this regard, we believe that the first part paragraph 3 would be more accurately worded as follows:

"A statement that the depositary's liability **shall be determined in accordance with Article 21(12) and** shall not be affected by any delegation of its custody functions unless it has discharged itself of liability in accordance with the requirements of Article 21(13) or (14)."

- We also note the reference in the second part of paragraph 3 to the "objective reason" for transfer to sub-custodians of the depositary's liability. ESMA's advice on this aspect will need to be consistent with its position in relation to Box 92. As we indicate below, we fully support Option 2, set out in Box 92, whereby the requirement for an objective reason is fulfilled where the AIF/AIFM has explicitly agreed that the transfer of liability is permitted. The contract appointing the depositary should not be required to include any further reasoning for the transfer and, in particular, there should be no requirement for the depositary or the AIFM to demonstrate, objectively (whether prospectively or retrospectively), that the discharge was in the interests of the AIF or investors. Consequently, we believe the words "including the objective reasons that could support that transfer" can be deleted from paragraph 3 of Box 79.

3.3 Depositary functions (section V.III)

3.3.1 Summary

Cash monitoring

- As regards the general information requirements (Box 75):
    - No liability should attach to depositary for failure on the part of the AIF/AIFM/third party provider to provide/procure accurate information;
    - The depositary's obligations must be understood as applying at the "head" level of an AIF (i.e. at the level of cash accounts actually held by depositary as top level, "global" cash accounts – and not at any other level). This applies to the depositary's obligations as regards cash accounts generally – so it also applies to the requirement to ensure that cash accounts are opened with banks in accordance with Article 18(1)(a) to (c) MiFID Implementing Directive;
    - Guidance should not be overly prescriptive as regards how the depositary may discharge its obligation to ensure that an AIF's cash flows are properly monitored and shall have regad to existing processes and procedures where possible.
- As regards the proper monitoring of cash flows (Box 76):
    - AIMA's clear preference is for Option 2 (ensuring that cash accounts are correctly opened, that the AIF/AIFM has appropriate procedures, periodic review and monitoring on a sample basis) as opposed to Option 1 ("central hub"/"mirroring" of transactions in cash accounts at third parties) which we consider to be unworkable;
    - We do not believe there is any requirement at Level 1 for a general operating account and subscription/redemption account to be opened at the depositary.

Safekeeping

- As regards the definition of financial instruments to be held in custody (Box 78), this should be limited (as regards non-bearer instruments) by reference to the following three criteria:
    - It should capture only transferable securities, money market instruments and collective investment undertakings as listed in Annex 1, section C of MiFID;
    - However, any such instruments that have been provided as collateral (see below) should be excluded; and

- Such instruments must be such that the depositary (or its sub-custodian) may instruct the transfer of title (or an interest therein) by means of a book-entry on the register maintained by a settlement system designated under the Settlement Finality Directive or a similar non-European settlement system (i.e. Option 2 in Box 78). In our view, this criterion stands as a good "proxy" for the concepts of transferability and fungibility which should define what can be held in custody. We believe that the alternative (which would simply look at whether the relevant financial instruments were registered or held in an account directly or indirectly in the name of the depositary) is unclear and confusing and might capture a number of investments which ESMA has indicated should not be included, including interests in partnerships or funds not traded on a regulated market, investments in privately held companies and real estate assets.

- Where financial instruments belonging to the AIF can be physically delivered to the depositary these should also be held in custody provided that title can be transferred by such physical delivery – i.e. they are genuinely bearer instruments (as opposed to registered securities in nominative form).

- As regards a right of re-use/rehypothecation:

  - Where the depositary has such a right over the AIF's financial instruments (regardless of whether or not it has exercised that right), it shall continue to be subject to its paragraph 8(a) obligations except where the depositary has exercised a right of use of collateral under a collateral arrangement;

  - Where a sub-custodian has a right of use, the depositary shall not be liable where:

    - The sub-custodian has exercised a right of use of collateral under a collateral arrangement;

    - The sub-custodian has an agreement with the AIF (or the AIFM on behalf of the AIF) which expressly grants the sub-custodian a right of re-use (e.g. under prime brokerage financing and collateral arrangements to which the depositary is not a party).

- Where financial instruments are transferred to a third party under a temporary lending agreement (e.g. a repurchase agreement or securities lending agreement) this involves a transfer of title (in return for a cash purchase price or cash/securities collateral). They are no longer custody assets. However, neither should they be treated as "other assets" as defined in Article 21(8)(b).

- As regards the treatment of collateral (Box 79):

  - we agree that the definitions in Article 2 of the Financial Collateral Directive can be used for the purposes of illustrating the types of collateral arrangement whereby the depositary will no longer have control and therefore the relevant financial instruments should no longer be held in custody. It is important to recognise that this is for the purposes of construing the AIFMD and specifically what should be excluded from the definition of financial instruments to be held in custody for the purposes of Article 21(8)(a) (see Box 78) – the arrangements would have to satisfy the "imported" Financial Collateral Directive definitions (as understood in the context of the AIFMD) but would not have to be financial collateral arrangements subject to the scope and application of the Financial Collateral Directive;

  - both title transfer and security financial collateral arrangements should be included (under the catch-all definition of "financial collateral arrangement"), not least to avoid the risk of the industry gravitating towards title transfer arrangements only;

- the concept of "security" should be understood widely to include any interests or rights in security (other than a title transfer arrangement), created or otherwise arising by way of security constituted under any law (this will include, amongst other things, pledges, mortgages, fixed and floating charges, liens etc);

- collateral shall be "provided" where it is delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral taker (or its agent).

- As regards safekeeping duties related to financial instruments held in custody (Box 80);

    - it is important that the depositary is subject to a standard of care one would expect to be undertaken by a global custodian in the countries/markets in which it is providing its services;

    - the depositary should not be required to assess the custody risks related to settlement systems – it would be more appropriate to limit any risk assessment to those matters which are within the depositary's reasonable control to address.

Oversight duties

- Generally:

    - There should be as little duplication with services provided by other service providers (e.g. valuers) to avoid inefficiency and uncecessary costs;

    - The Level 1 text sets depositary obligations in terms of procuring that appropriate *procedures and controls* are in place – oversight should be understood as just that: the depositary should not be required to "police" matters at a "micro" level

- As regards the general requirements (Box 82):

    - AIMA agrees that the depositary should set up procedures and processes which are proportionate to the estimated risks and that the depositary should be able to assess the efficacy of the procedures in place – this would include ex post *verifications* (on a sample basis) of outcomes but not ex post "controls";

    - Duplication with functions performed by others (e.g. the valuer or other service provider) should be avoided;

- As regards duties relating to subscriptions/redemptions (Box 83):

    - The depositary should not be required systematically to police the AIF/AIFM's operations;

    - Subscriptions and redemptions are unlikely to be the depositary's primary responsibility – and its oversight duty should be understood accordingly, based on information from the administrator under contractual arrangements;

    - The depositary's role should be to ensure that appropriate procedures regarding investor acceptance and reconciliation are in place;

- As regards the valuation of shares/units (Box 84):

    - The depositary's role is not to duplicate that of the valuer;

- Instead, the depositary should verify the existence of processes and procedures in respect of valuations (these should not be overly prescriptive in Level 2 measures);

- As regards carrying out of the AIFM's instructions (Box 85):

  - The Level 1 text does not require the depositary to police the AIFM's compliance; rather, it should ensure that suitable procedures exist and are maintained

- As regards timely settlement (Box 86):

  - AIMA prefers Option 1 (no additional requirements regarding timely settlement);

  - Option 2 (requiring the setting up of a procedure to detect any situation where consideration is not remitted to the AIF "within usual time limits" etc) is unduly burdensome and goes beyond what the Level 1 text requires: the depositary should not be required to "police" receipt of consideration.

Segregation

As regards segregation obligations for third parties to which depositaries have delegated part or all of their safekeeping functions (Box 89):

- AIMA strongly supports ESMA's recognition, in the explanatory notes to its draft advice, of the use of omnibus accounts by sub-custodians. This should, however, be made absolutely explicit in its advice to the Commission in Box 89.

3.3.2 Cash Monitoring – general information requirements (Box 75)

Whilst the general information regime is unlikely to be unduly onerous (as regards the maintenance of records of cash accounts opened in the name of the AIF or in the name of the AIFM acting on behalf of the AIF), we would make the following observations:

- In order to obtain information as to an AIF's cash arrangements, a depositary will need to receive that information, in a timely manner, from the relevant AIFM (or its other service providers). Consequently, it will be important for the depositary agreement to oblige the AIFM to provide such information, or to procure its provision by those with whom it opens or arranges third party accounts. No liability should attach to the depositary for a failure on the part of the AIFM/AIF, or of any third party provider, to provide or procure accurate information - this is in line with the explanatory text beneath Box 75.

- Consistent with our responses elsewhere in this Section V.III, we believe that a proper reading of the Level 1 text on this point is that the obligations of the depositary should apply only in respect of cash and accounts at the "head" level of an AIF. By "head" level, we mean the level of the cash accounts actually held in the name of the AIF/AIFM for the AIF as top level, "global" cash accounts, and not any of the (possibly numerous) sub-accounts held with sub-custodians or bank correspondents. We do not believe that the text of Article 21(7) seeks to address the complexities of cash holdings beneath the head level. Consequently, we are firmly of the view that Article 21(7) obliges the depositary to maintain information only in respect of "head" level accounts, rather than tracking further down the sub-custody chain. We believe this to be entirely consistent with references to accounts being those opened by, or in the name of the AIF, or by the AIFM acting on its behalf. We suggest minor changes to Box 75, above.

- The Directive does not require, nor would it be appropriate to impose, overly-prescriptive guidance on the question of what steps would amount to the depositary "ensuring that the AIF's cashflows are properly monitored". Given the broad spreads of arrangements employed by AIF, flexibility of approach to "proper monitoring" is key. Again, given the reliance of the depositary on the AIFM for the provision of this information, Article 21(7) requires the depositary to oblige

the AIFM to provide information regarding "head" level cash accounts (to the extent that those are not held with the depositary itself). Importantly, and in line with paragraph 4 of the relevant explanatory text, whilst the depositary must be given information as to accounts, and access to information allowing a "clear overview", Article 21(7) does not require the depositary to have a detailed "policing" role. Rather, the depositary should ensure that suitable cash flow monitoring procedures are in place in respect of the AIF, and that suitable information is therefore available as required.

We suggest the following amendments to the text of Box 75:

> The AIFM should ensure that the depositary is provided, upon commencement of its duties and on an ongoing basis, with all relevant information it needs to comply with its obligations pursuant to Article 21 (7) including by third parties and particularly that:
>
> - the depositary is informed, upon its appointment, of all existing cash accounts opened **in the name of** the AIF, or **in the name of** the AIFM acting on behalf of the AIF;
> - the depositary is informed prior to the effective opening of any new cash account in **the name of** the AIF or **in the name of** the AIFM acting on behalf of the AIF;
> - the depositary is provided with **access to** all information related to the cash accounts opened **in the name of the AIF, or in the name of the AIFM acting on behalf of the AIF** at a third party entity, directly from those third parties, in order for the depositary to have access to all information regarding **such** cash accounts and **to** have a clear overview of all the cash flows **affecting these accounts**.
>
> Where the depositary does not receive this information, the AIFM will have been deemed not to have satisfied the requirements of Article 21of the directive.

3.3.3 Proper monitoring of all AIF's cash flows (Box 76)

AIMA is pleased to note that neither of the options proposed would amount to an "ex-ante" approval regime - we believe that such an approach would be outside the meaning or intention of the Level 1 text. That said, we believe that Option 1 (involving a "central hub" and, where cash accounts are opened at a third party, "mirroring" of transactions) would practically be as unworkable as an "ex ante" regime.

Our clear preference is therefore for Option 2 (subject to some amendments on our part). In our view this reflects the Level 1 requirements better and is more realistic.

See our detailed comments in response to Q29 below.

As has been noted by AIMA (and others) in previous consultations, any regime which would impose any requirement for prior notification of or consent to cashflow movements would be unworkable given the volume of such movements (estimated at 150,000 individual cash movements relating to AIFM activity in Europe each day). As well as being practically unworkable, AIMA believes that any requirement for advance consent or notification would be both unnecessary given the prevalence of "delivery versus payment" settlement (estimated to comprise more than 90% of cash movements relating to the settlement of transactions). Article 21(7) does not require prior notification or approval and no such interpretation should be placed on these provisions. If they were to be required, it would result in very significant problems between AIF, their AIFM and counterparties.

More specifically:

- Any ex-ante consent regime would necessitate the implementation of real time communication links between the depositary and those maintaining the accounts. Given the complexity of cash arrangements, the cost of this would be formidable, and, indeed, many third parties may be unlikely to agree to do it. Even if information was provided, it is difficult to believe that

all such third parties would agree to comply with the need for depositary consent to cash movements.

- Any requirement for prior consent would effectively limit the speed at which trading could take place. High volume trading strategies in particular would be impacted as these rely on sophisticated technology to enter into and reverse positions on an intra-day basis with execution as an automated process. It would be impossible to institute a prior approval regime in these circumstances.

- Even if an AIF/AIFM is not operating a high volume trading strategy any ex ante consent regime would inevitably slow down the settlement process cycle with a commensurate rise in settlement risk and processing costs.

- An ex-ante consent regime would actually create legal risk for AIFs. A depositary, likely a stranger to the contracts under which an AIF is obliged to pay or receive cash, would have no power to alter the AIF's legal obligation to pay under that agreement, but could prevent fulfilment of that obligation. Were the depositary to refuse the related cash movement, the AIF would be in breach of a binding contractual obligation and face liability to the counterparty accordingly.

AIMA's belief that any ex-ante approach would be an improper interpretation of the Level 1 text is consistent with our firm position that interpretation of the Level 1 text should not be stretched so as to require the depositary to "police" the AIFM or AIF on day-to-day matters. It is not, and should not become, the role of a depositary to get involved in any qualitative assessments regarding particular trades or cash movements.

3.3.4 Ensuring the AIF's cash is properly booked (Box 77)

We suggest some amendments to the text of Box 77 as follows:

- in paragraph 1, delete the words "AIFM complies" and replace them with "AIF, or AIFM has appropriate procedures in place ensuring its compliance";

- in paragraph 2, insert after the word "ensure" the words "that the AIF or AIFM has appropriate procedures in palce to ensure that".

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?

We do not believe that any such requirement is expressed or implied by Article 21 (7). Whilst it may be the case that many AIFs would retain one or more cash accounts with the depositary, AIMA does not believe it is feasible to impose an absolute requirement that a "general operation account" and subscription/redemption account should be opened at the depositary. Given the wide variety of fund strategies and trading arrangements, there may, of necessity, be wholly valid reasons for an AIF, via its AIFM, to establish accounts purely with third parties. This approach would not prevent the transmission of information to the depositary or the establishment of appropriate monitoring procedures, which AIMA believes to be the intention of the wording in Article 21(7).

Any obligation mandating the opening of accounts with the depositary itself would seem to cut across the express provisions of Article 21(7), which directly envisages the use of third party accounts.

Any obligation to maintain accounts at the depositary, presumably for verification purposes, would not sit well with the apparent intended interaction between Articles 21(7) and 21(8)(b). Article 21(7) can

only sensibly be construed, given the breadth of its drafting, to draw a distinction between cash monitoring obligations in that provision and the asset verification obligations applicable pursuant to Article 21(8)(b). In our view, Articles 21(7) and (8)(b) are mutually exclusive, but complementary, regimes for cash and other assets.

Turning specifically to subscription accounts, subscription monies may not actually be fund assets until the acceptance of the relevant subscription. Further, these accounts need to be maintained wherever is most administratively expeditious in order that the investor acceptance procedures of an AIF (as operated by the relevant administrator) can be efficiently handled, and this may mean that the account is best suited to sit with an institution other than the depositary itself. This is not to say that the depositary should have no role in respect of a subscription account - the depositary should have an equivalent responsibility to ensure that processes and procedures for the proper reconciliation of subscription amounts to accepted investments are put in place, but we see no reason why that would equate to an obligation to maintain the subscription account with the depositary.

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

The frequency of reconciliation of cashflows in open-ended AIF with standard liquidity may commonly be daily, but is unlikely to be more frequent. The type of assets in which the AIF invests may well have an impact on the frequency of reconciliation of cashflows, as may the liquidity terms of the fund in question. A closed-ended private equity fund which deals only infrequently may well have a less frequent reconciliation schedule than an open-ended fund with a very active trading strategy.

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

Please see our comments under 3.3.2 (second bullet point) above. It must be made clear that the obligation on the part of the depositary to ensure that cash of the AIF is booked in cash accounts at an entity referred to in Article 18(1)(a) to (c) of the MiFID Implementing Directive applies at the "head" level. If paragraph 2 of Box 77 were to be construed as requiring such booking in the various sub-accounts held with sub-custodians or bank correspondents this would present significant, if not insurmountable practical problems (as well as being an incorrect reading of the Level 1 text).

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

We do not see material difficulties regarding accounts opened at prime brokers, per se. There will need to be created an appropriate contractual and practical matrix allowing notification of the opening of accounts and access for the depositary to information held by the prime broker, but it is anticipated that this would have only moderate cost implications.

However, this is predicated on an interpretation of Article 21(7) under which the depositary's obligation is to ensure the proper monitoring of the AIF's cashflows through the instigation (and monitoring) of suitable cashflow monitoring procedures. If a different interpretation of the term "ensure" is taken, and a depositary is given a direct "policing" role in respect of cashflow monitoring then this may cause significant difficulties as it is likely that a direct and potentially complex relationship will need to be created between the depositary and PB.

Further, our comments above are also dependant on an approach which imposes obligations only in respect of cashflows or accounts at the "head" level (as described in our response under Box 75). If it is necessary to engage with a prime broker as regards accounts at subsidiary levels then this would lead to a potentially unworkable degree of complexity.

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

AIMA supports a slightly modified version of option 2.

Option 1 (the "central hub" approach) is, we believe, unworkable. Whilst perhaps not as difficult as an ex ante consent mechanism (see above), a regime which would require the mirroring of cash transactions on third party accounts would be impractical, unwieldy and extremely costly. It would also likely result in the multiplication of errors occurring anywhere within the cash system of AIF, and would create substantial delay. Further, and importantly, given ESMA's mandate, it would require an interpretation of the wording of Article 21(7) which goes beyond its natural meaning.

Article 21 (7) requires the depositary, "in general", to ensure the monitoring of the AIF's cashflows. This "general" obligation should not be interpreted so as to give a requirement that every payment/cash movement is monitored/policed by the depositary. Rather, it requires the oversight by the depositary of the establishment of suitable cash monitoring procedures. The imposition of a "central hub" would require the simultaneous transmission of all cashflow events from any third party cash account, thereby going considerably beyond the scope of the Level 1 text.

AIMA notes also the comment in Paragraph 8 of the explanatory notes to this, which states "*as a consequence, the depositary could intervene immediately if it considers cashflows inappropriate*".

As stated in our response under Box 76, above, it is not appropriate for the depositary to have a policing role in respect of payments, nor is that consistent with the Level 1 text. In any event, as is noted above, it is difficult to see precisely what intervention could be made with significantly increasing risk for the AIF, the depositary and the counterparty concerned by interference with third-party contractual obligations. This is certainly the case if such intervention would result in a de facto prior approval system being introduced. The difficulties of intervention are apparently acknowledged in Paragraph 8, which goes on to state "*however this does not mean that the depositary would take part in the management of the fund. The investment decisions remain in the sole hands of the AIFM*". If this is the case, then it is difficult to see what form of "immediate intervention" is intended?

Option 2 is significantly closer to what AIMA believes would be an appropriate and proportionate system, and a valid interpretation of the Level 1 text.

The description in paragraph 9 of the explanatory text on this section describes the depositary's obligations as "*verifying that there are procedures in place to appropriately monitor the AIF's cashflow and that they are effectively implemented and periodically reviewed".* This seems consistent with the intention of Article 21 (7) to provide a regime under which the depositary "*shall in general ensure that the AIF's cashflows are properly monitored*".

As above, the Level 1 wording does not impose a direct reconciliation/monitoring obligation on the depositary itself, rather, it requires the implementation of appropriate procedures to ensure that cashflows are properly monitored. Sub paragraphs 1, 2 and 3 of Option 2 all reflect this position. As a general comment on this option, it would greatly aid efficiency at all levels in the industry if it were possible to avoid the need to create new obligations in terms of verification materials. In particular, AIFMs already produce significant volumes of material as part of their audit processes, which could readily be provided to a depositary for verification purposes.

One point on paragraph 3 of Option 2 is that there is proposed to be a requirement that procedures be implemented to "identify on a timely basis significant cashflows and in particular those which could be inconsistent with the AIF's operation". Taking the three key elements of that sentence in turn:

- First, there is the question of what is a "timely" basis?

- Second, what is a "significant" cashflow?
- Third, what would be a cashflow "inconsistent with the AIF's operation"?

On the first two points, in AIMA's view the diversity of AIF and situations which would be covered by this regime strongly indicates view that any provisions in this regard must avoid over prescription. What is "timely" or "significant" in respect of one AIF may be radically different from that in another. The term "inconsistent with the AIF's operation" raises a different issue. As stated above, Article 21(7) does not impose a policing obligation on the depositary. Therefore, whilst it would not be inconsistent with the Article 21(7) text to require the depositary to ensure that appropriate procedures are in place to identify those items/cashflows which would be regarded by the AIFM as inconsistent, there should be no obligation on the depositary to police such a regime, or indeed to determine what amounts to inconsistency.

Paragraph 4 of Option 2 appears to be consistent with the Article 21(7) text, requiring a review on (at least) an annual basis. This appears to us to be workable, and permits important flexibility within the system.

One aspect of Option 2 which AIMA finds problematic, having regard to the Level 1 text, is the obligation in paragraph 5 of Option 2 to "*monitor on an ongoing basis the outcomes and actions taken as a result of those procedures and alert the AIFM if an anomaly has not been rectified without undue delay*".

Aside from the ambiguous terms in that sentence, its approach runs contrary to the principle that it is the role of the depositary to "*in general terms ensure that the AIF's cashflows are properly monitored*". As above, those words do not create an obligation on the depositary itself to monitor/police every individual transaction, but rather to oversee the implementation of proper procedures. On this basis, the proper requirement here would be for the depositary to ensure that the procedures in place have suitable monitoring and exception reporting elements, together with an "alert" mechanism and notification/escalation procedures allowing action to be taken by the AIFM to rectify any anomalies.

We therefore propose the following amendments to Option 2 in Box 76 as indicated by the underlining below.

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

Q30:
What would be the estimated costs related to the implementation of option 1 or option 2 of Box 76?
The study commissioned by AIMA suggests that Option 1 would be entirely unworkable/operationally impossible for some firms (essentially forcing them out of the market) or for others, result in a significant increase in costs (estimates vary from a 30% to 100% increase in running costs, together with additional costs for building new systems etc. Please see our comments at the beginning of Section 3.

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

Please see the answer to Q30.

3.3.5 We have proposed certain amendments to Option 2 in Box 76, above. Definition of financial instruments to be held in custody – Article 21 (8) (a) (Box 78)

AIMA agrees that the first criterion, as set out in Box 78, should be limited to transferable securities, money market instruments or units of collective investment undertakings as listed in Annex I, section C of Directive 2004/39/EC.

We also agree that any such instruments (as listed in the first criterion) which are provided as collateral should not be regarded as held in custody (see below for our detailed comments on when instruments are provided as collateral).

As regards financial instruments which "can be physically delivered" we agree that these should be instruments that can be held in custody provided that there is a clear understanding as to what this means. We believe that the wording within Box 78 would be better expressed as follows:

> "Additionally, financial instruments ***title to which is transferred by delivery of a physical instrument (i.e. bearer instruments rather than registered securities in nominative form)*** shall be held in custody."

This wording makes a clear distinction between bearer (and similar) instruments and instruments in nominative form. In the latter case, there is a certificate which *evidences* title to the instrument and which could therefore be "physically delivered" to the depositary, but crucially such delivery would not effect a transfer of title; it is clear from paragraph 17(c)(iii) that these are not the instruments to which paragraph 8(a) refers.

More generally, we welcome the inclusion of a non-exhaustive list of "other assets" (as in paragraph 29). However:

- the penultimate bullet point should also refer to a "security interest financial collateral arrangement" where the collateral has been delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral taker (or a person acting on the collateral taker's behalf) – please see our comments in relation to treatment of collateral, Box 79 below;

- We do not believe that the final bullet point should be included in this list – cash (whether or not booked with a third party), is subject to the provisions of Article 21(7), not Article 21(8)(b) and therefore the distinction between custody assets and "other assets" is not relevant in this context. In other words, Article 21(7) and Article 21(8)(b) are mutually exclusive, with Article 21(8)(b) setting out the depositary's obligations as regards non-cash assets that do not satisfy the criteria in Box 78 (subject to our comments above).

- An additional bullet point should make it clear that investments in privately held companies and interests in partnerships or collective investment undertakings not traded on a regulated market

are 'other assets' – this is consistent with ESMA's comment in paragraph 26 of its explanatory text, with which we agree.

Q32:
Do you prefer option 1 or option 2 in Box 78? Please provide reasons for your view.
AIMA's strong preference is for Option 2 (subject to the comments below).

We believe that Option 1 is highly unsatisfactory as currently drafted because:

- Option 1 is not clear (despite its apparent simplicity) and risks confusion which will undermine the *a contrario* approach.

- The depositary should only be treated as holding financial instruments in custody pursuant to paragraph 8(a) if it can effectively instruct the transfer of title to financial instruments (which satisfy the first two criteria) – Option 1 does not include this concept and could therefore capture situations where the depositary would have not such power or control.

- Following on from that, there are circumstances in which securities can be registered or held in an account in the name of the depositary but over which it does not have control. The circumstances in which control may have been ceded are not limited to the giving of collateral. See, for example, the use of escrow in the CREST settlement system in the UK which is used for a variety of purposes, including acceptance of take-over offers. The wording in Option 2 addresses this issue but Option 1 does not.

- A financial instrument should only be held pursuant to the requirements of paragraph 8(a) if it meets certain criteria – e.g. it is freely transferable and fully fungible with all other instruments of the same class. Conversely, as we have mentioned in our previous submissions, by way of example, interests in partnerships or alternative investment undertakings (shares or units) not traded on a regulated market are not assets which a depositary can safe-keep, typically because one or more of the following applies – they not freely transferable, not fungible, not registered and/or they carry obligations on the part of the holder. Option 1 makes no recognition of this. By contrast Option 2 incorporates this overriding principle because similar requirements are imposed as a general matter in the criteria for admission of securities to CSDs.

- As indicated above, paragraph 17 clarifies that certain securities held in nominative form are not intended to fall within paragraph 8(a); yet, as currently drafted, Option 1 could include such instruments and would therefore go beyond the Level 1 text.

- There is no clarity as to what the wording "directly *or indirectly* in the name of the depositary" is actually intended to mean – we do not understand how instruments can be registered or held in an account "*indirectly in the name*" of the depositary.

- Despite paragraph 26 of the explanatory text, Option 1 does not (and therefore Box 78 would not) make it clear that investments in privately held companies or real estate assets are not caught – the wording of Option 1 could catch such investments.

By contrast, we favour Option 2 because:

- It is clearer and more objective in defining financial instruments *capable of being held in custody* as those in respect of which the depositary has the power to instruct their title transfer (either itself or through its sub-custodian) through a settlement system (as designated under the Settlement Finality Directive) or a "similar non-European securities settlement system". We believe this reflects the requisite degree of "control" over financial instruments we would expect to see from a custodian holding assets in custody – i.e. the power to give non-discretionary settlement instructions - to be distinguished from situations where such power is out of its hands (for instance where it is in the hands of the AIF/AIFM itself or a third party (for instance under a collateral arrangement)).

- It incorporates, by "proxy", the concepts of transferability and fungibility etc (referred to above) (because CSD admission criteria specify similar requirements).

We do not, however, understand the words "which acts directly for the issuer or its agent" in Option 2, a qualification which we believe is only intended to apply to a non-European securities settlement systems. We understand the intention behind the reference to non-European securities settlement systems to capture such systems as are essentially analogous to those designated under the Settlement Finality Directive. However, we do not believe it is correct to describe any securities settlement system (whether European or non-European) as acting directly for the issuers of financial instruments (or their agents) and therefore do not understand what ESMA intends to describe here. We suggest the deletion of these words, which were perhaps included in error.

We are puzzled by the explanation in the final sentence of paragraph 28. Assuming the intention is to refer to relevant financial instruments which are registered in the sole name of the depositary in the register maintained by the relevant European or non-European securities settlement system then we are not sure why (assuming the depositary has the requisite power to instruct the transfer of title) such instruments should not be capable of being held in custody.

Rehypothecation/right of re-use

In Box 78 (and as later referred to in paragraph 34 of the explanatory text) ESMA suggests stating that when the AIF or the AIFM has given its consent for the re-hypothecation by the depositary of financial instruments held in custody, those instruments remain in custody, whether or not the right of re-use has been exercised.

We agree that, as a matter of principle, where the depositary has a right of re-use over paragraph 8(a) financial instruments, then, regardless of whether or not it has exercised that right of re-use, the depositary should continue to be subject to its paragraph 8(a) obligations and the associated liability provisions. However, that should not be the case where the depositary has exercised a right of use of collateral under a collateral arrangement (see our comments below on the treatment of collateral).

The statement in Box 78 (and in paragraph 34) relates specifically to the right of re-use *by the depositary*. It is not clear to what extent (if it all) ESMA intends to address a right of use held or exercised by a sub-custodian. If it does, then our comments in relation to collateral apply equally to this situation. In addition, as a matter of principle, the depositary should not be liable in circumstances where the sub-custodian has an agreement with the AIF (or the AIFM on behalf of the AIF) which expressly grants a right of re-use; an example of this will be where the sub-custodian is acting in the capacity of prime broker to the AIF/AIFM and the right of re-use forms part of the overall financing and collateral arrangements to which the depositary is not a party.

Treatment of temporary lending/repurchase agreements

Box 78 states that where financial instruments have been provided by the AIF or the AIFM acting on behalf of the AIF to a third party under a "temporary lending agreement", they will no longer be held in custody by the depositary and will fall under the definition of 'other assets' in accordance with Article 21(8)(b). This is echoed in Paragraph 34 of the explanatory text which states that where financial instruments are subject to a repurchase agreement, they are no longer considered as belonging to the AIF and should be considered as "other assets" as defined in Article 21(8)(b).

We assume that, when using the term "temporary lending agreement", ESMA intends to refer to securities lending agreements and repurchase agreements (commonly referred to as "repos").

AIMA agrees that where financial instruments are repo'd out or subject to a securities loan (i.e. sold to a counterparty for a purchase price under a repo, or "lent" to a "borrower" under a securities loan), those financial instruments should no longer be considered as belonging to the AIF – the financial instruments will no longer appear on the depositary's books as being held for the AIF. This is true of any title transfer collateral arrangement – see our comments above - or indeed any transfer of full ownership or title – both repos and securities loans involve absolute transfer of title.
However, we take issue with ESMA's assertion that the financial instruments subject to a repurchase agreement (i.e. repo'd out) (or for that matter those "lent" under a securities loan) should be considered as "other assets" as defined in Article 21(8)(b). We set out below a simplified description of the

temporary lending arrangements to which we believe ESMA refers in order to illustrate why we believe it is wrong to refer to repo'd or lent securities as being "other assets".

In a repo transaction under a repurchase agreement, where the AIF/AIFMD is the seller (in economic terms it is a cash "borrower", securing the "loan" by providing securities collateral to the "lender") the AIF/AIFMD will have a *contractual* right to delivery of equivalent financial instruments provided as collateral. Depending upon the terms of the repo, this may be on a specified delivery date or on demand. For as long as the repo is outstanding, the AIF/AIFMD can use the cash it has received as its own and the repo counterparty can use the financial instruments as its own (since it has received full title to them). This cash should fall to be treated under paragraph 7 (to the extent relevant). Where the financial instruments have been repo'd out, the AIF/AIFMD no longer has any ownership rights in relation to them and clearly the depositary should not be under any Article 21(8)(b) requirement to verify the AIF's (non-existent) ownership. Furthermore, (although this is not how paragraph 34 is worded) we do not believe that the depositary can have any obligation to verify the AIF's "ownership" of the contractual right to the delivery of equivalent financial instruments at the end of a particular repo. We doubt whether it would be correct to describe this contractual right as an "asset" to which a depositary's duties should apply. In any event, if the depositary were required to treat the contractual right to delivery of equivalent financial instruments as "other assets" this would effectively involve "double-counting" of assets, since the cash would belong to the AIF for the duration of the repo and be subject to paragraph 7. On the repurchase date of a repo, the AIF/AIFMD will be required to pay a repurchase price out of its cash whereupon it will receive from the counterparty equivalent securities to those which it sold on the purchase date. On receipt of those equivalent securities, the depositary will hold them in custody under paragraph 8(a).

Under a securities loan transaction under a securities lending agreement, when the AIF/AIFMD is the "lender", it will transfer title to relevant financial instruments to a third party (the "borrower"). In return, the AIF/AIFMD will receive "collateral". That may in the form of cash or financial instruments. Where that collateral is cash, it should fall to be treated under paragraph 7 (as with cash received under a repo). Where that collateral is comprised of financial instruments, since the AIF/AIFMD will receive absolute title to them, they will be held in custody for the purposes of paragraph 8(a). For the same reasons given above in respect of repos, we do not believe it makes sense for the depositary to be under an obligation to treat the contractual right to delivery of instruments equivalent to those lent to the "borrower" on the expiry of the securities loan as "other assets". On the expiry of the securities loan, the AIF/AIFMD will receive equivalent financial instruments to those it originally "lent" (these will become custody assets) and will return the cash or securities collateral to the lender.

The AIF may, of course, be the "borrower" under a securities loan, in which case the "borrowed" financial instruments will be held in custody (unless and until title to them is transferred to a third party). The AIF/AIFM will be required to deliver "collateral" to the "lender", either by way of cash or financial instruments. The depositary should not be required to treat any such cash or financial instruments as being subject to paragraph 7 or 8. On the expiry of the securities loan, the AIF/AIFMD will be required to deliver equivalent financial instruments to those it originally "borrowed" (these will cease to be custody assets) and will be entitled to receive cash or securities equivalent to the collateral it originally provided – these will be subject to paragraph 7 or 8(a) as applicable.

Please note that we have used the terms "lender" and "borrower" in inverted commas in order to denote the fact that these temporary lending arrangements legally involve the transfer of title of assets.

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?

At the highest level, when considering what kind of financial instruments are held in custody, current market practice (certainly from a UK perspective) focuses on "securities" – i.e. transferable assets (most typically, to the extent that they are traded on regulated markets and freely transferable, equities and debt instruments, MMIs and units in CIUs). This tallies with ESMA's current proposals.

AIMA believes that it is important to distinguish between (i) what custodians are conceptually able to safekeep and (ii) assets which may be in some way subject to the terms of a custody agreement and in

respect of which the custodian may well provide ancillary services, but which the custodian cannot meaningfully safekeep (for instance, because they are purely contractual rights, not freely transferable, not fungible and/or they carry obligations on the part of the holder). We believe that the criteria as specified in paragraph 1 of Box 78 (as qualified by the criteria in paragraphs 2 and 3 (Option 2), subject to our comments above) would accurately reflect this distinction.

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

We do not have any comments in addition to our responses to the question below.

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?

We would reiterate that AIMA is supportive of the idea of using terminology from the Financial Collateral Directive (FCD) for the purposes of illustrating the types of collateral arrangement whereby the depositary will no longer have control and therefore the relevant financial instruments should no longer be held in custody for the purposes of paragraph 8(a). The virtue of using such definitions for the purposes of the AIFMD's Level 2 measures is that they are concepts that are already recognised in European legislation (and therefore in national implementing measures).

However, we believe it is critical to ensure that the use of such definitions does not have the effect of stipulating that the arrangements must be such that they are *within the scope* of the FCD before they can be considered as "collateral" (and therefore not paragraph 8(a) instruments).

For instance, Article 1(2) of the FCD prescribes the categories which the "collateral taker" and "collateral provider" must fall into. Broadly speaking, at least one of them must be a public authority, a central bank, a financial institution subject to prudential supervision (this includes credit institutions, investment firms and UCITS) or a central counterparty, settlement agent or clearing house. An AIF as collateral provider would not fall into any of these categories (even if the AIFM might) and in many cases the collateral taker would not either. Furthermore, the definitions within the FCD are complicated and densely drafted and involve cross-references of interdependent words and concepts. The definitions of "title transfer collateral arrangement" and "security financial collateral arrangement", for instance, both include the terms "collateral taker" and "collateral provider".

In addition, Article 1(4) of the FCD provides that "financial collateral" shall consist of cash, financial instruments or credit claims and there is a risk of a mismatch between the FCD definition of "financial instruments" and the definition of "financial instruments to be held in custody" for the purposes of paragraph 8(a) of AIFMD.

Therefore, it is important to avoid the situation where, on a detailed construction of the terms of the FCD, the result is that the definitional concepts being "borrowed" from the FCD are unintentionally narrowed or, indeed, rendered entirely inapplicable.

In our view, this therefore means that it must be clear that, as far as possible, the definitions are being "imported" on a stand-alone basis from the FCD for the purposes of defining collateral arrangements for the purposes of the AIFMD level 2 measures, without also carrying with them the associated requirements of the FCD as regards scope and application.

Our following comments are made in the light of the above.
The wording of Box 79

First, we agree that as a matter of principle the definition of "title transfer financial collateral arrangement" as it appears in the FCD would accurately encompass the types of *title transfer* collateral arrangements which, if effected over the AIF's assets, would of necessity mean that they would no longer be in the custody of the depositary. We would make the point that, since such arrangements involve a transfer of absolute title, there is no reason why such a transfer should be treated differently to any other transfer of title, for instance on a sale of relevant financial instruments.

Second, we believe that security arrangements should also be covered, so Option 1 would not in any event be sufficient by itself. There is a risk that, if the provisions of Box 79 are limited to title transfer collateral arrangements then the industry may gravitate towards such arrangements (with the attendant counterparty risk that the AIF will assume as regards the collateral-taker) to the exclusion of more flexible (and arguably less risky) security arrangements.

Option 3, as amended, is preferred

Option 3 is, on the face of it at least, the simplest and most elegant solution insofar as it seeks to incorporate by reference the definitions of "title transfer financial collateral arrangement" and "security financial collateral arrangement" (and other definitions) in Article 2 of the FCD.

However, as stated above, the definitions within the FCD are complicated and involve cross-references of interdependent words and concepts. Therefore we are concerned that the apparent simplicity of Option 3 might be open to misconstruction. We therefore believe that a variant of Option 3 would be preferable and propose the following text for Box 79 which uses the wording of and/or concepts within the relevant definitions in the Financial Collateral Directive but which does have the effect of importing other provisions of the FCD which, on a construction, might defeat the object of referring to that Directive:

"Financial instruments provided as collateral shall not be held in custody if they are provided by the AIF (or the AIFM acting on behalf of the AIF) under a financial collateral arrangement as defined and construed in accordance with Article 2 of Directive 2002/47/EC on financial collateral arrangements (the "Financial Collateral Directive").

For the purpose of further construing the above provisions:

(a) The provisions of the Financial Collateral Directive, other than Article 2, shall not be taken into account;

(b) "Collateral provider" shall be the AIF (or the AIFM acting on behalf of the AIF) and "collateral taker" shall be any third party;

(c) "Security" for the purposes of the definition of security financial collateral arrangement shall mean without limitation any interest or any right in security, other than a title transfer financial collateral arrangement, created or otherwise arising by way of security constituted under any law, including (without limitation) a pledge, mortgage, fixed charge, floating charge or lien;

(d) "Financial collateral" shall mean financial instruments as defined in Box 78, paragraph 1."

While we accept that this is somewhat more complicated than the wording of ESMA's Option 3 we do believe that careful drafting is required in order to correctly capture the types of arrangement which should not be considered to be in the custody of the depositary.

The modified wording as set out above would incorporate, by reference, the concept of financial collateral being provided if it is delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral taker or of a person acting on the collateral taker's behalf (Article 2(2) FCD).

While we agree with what we understand to be the intention behind ESMA's comments in paragraph 33 of its explanatory text, we nevertheless take issue with the text of ESMA's draft Option 2 and the wording in paragraphs 32 and 33 to the extent that there is a (probably unintended) implication that the only way that instruments subject to a security financial collateral arrangement could ever stop being held be in custody would be if they were simply transferred out of the depositary's books altogether (for example, control can be delivered without any movement out of the depositary's account). Box 79 should capture transfers of financial instruments to a separate account in the name of the collateral-taker (or a person acting on its behalf whether such account was with a third party or on the depositary's

books. It should also take account of the fact that possession or control could be transferred away by various means, including by way of registration or designation (i.e. not just by transfer out of the depositary's books).

In light of the above, we would prefer it if the final sentence of paragraph 33 of the explanatory text made it clear that, *by way of example*, where there has been a transfer of financial instruments from the account of the AIF (or the AIFM acting on behalf of the AIF) to a separate account in the name of the collateral-taker or a person acting on its behalf, *including where such separate account is opened on the books of the depositary*, then the financial instruments so transferred would no longer be in custody. It could then go on to state that, although perhaps less common, there may be circumstances in which there has been no such transfer but a collateral-taker has been granted rights of control over the account which the AIF/AIFM has with the depositary (including by way of an effective "blocking" of such account) such that there is no longer any *de facto* control over that account on the part of the AIF, AIFM or the depositary.

3.3.7 Safekeeping duties related to financial instruments that can be held in custody (Box 80)

As regards paragraph 1(a) of Box 80, we believe this should read as follows:

"(a) Ensure that the financial instruments are properly registered **on its books** in segregated accounts in order to be identified at all times as belonging to the AIF."

This is to make it clear that this requirement relates to segregation at the level of the depositary's own books and records only. Please see our comments in relation to Box 89 below.

As regards paragraph 1(b) of Box 80, AIMA's view is that the proposed standard of care is set at an unreasonably high and impracticable level insofar as it purports to qualify that standard by requiring the deliverance of an objective outcome ("to *ensure* a high level of protection"). It may not be possible to deliver this outcome in all markets. Our preference is for a formulation which accords more closely to the standard of care one would expect to be undertaken by global custodians in the market. Our proposed wording is as follows:

"(b) Exercise in relation to the financial instruments held in custody the due care that would reasonably be expected of a professional custodian providing safekeeping services within the countries and markets in which the depositary performs such obligations."

As regards ESMA's suggestion in paragraph 1(c) of Box 80 AIMA is strongly of the view that this goes well beyond anything for which technical advice would be required for the purposes of implementing measures for Article 21(8) of the Directive and is also not within the scope of the European Commission's Request for Advice. We do not believe, especially given the nature of the investors (AIFs and AIFMs), that the depositary should be required to assume the burden and costs of having to perform a due diligence exercise in assessing the risks associated with the settlement systems, CSDs or registrars for the jurisdictions in which the AIF/AIFM chooses to invest (these risks are technically not "custody risks" as ESMA has described them).

Most settlement systems are large and complex, the complexity extending to their organisation, legal arrangements, IT systems and, in many cases, supporting arrangements with other settlement systems or custodians. It is often not practical, and would certainly be very costly, for a depositary to undertake such a risk assessment on anything other than a superficial level. Some CSDs commission reviews which they make available, but this will not be a universal practice worldwide. It is utterly disproportionate to require a depositary to undertake this assessment in circumstances in which it can, as ESMA accepts, do nothing to manage the risks which are identified as a result of this process.

It would seem more appropriate to limit any risk assessment to those matters which are within the Depositary's reasonable control to address. This would complement the liability framework in Article 21. The provisions of paragraph 2 of Box 80 relate to delegation and we consider these in the context of those provisions (see later).

3.3.8 Safekeeping duties related to 'other assets' – Ownership verification and record keeping (Box 81)

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

AIMA is somewhat puzzled by this question in this context. Although we do not believe this is what ESMA is implying by its question, we do want to make it clear that we do not consider that the fact that the depositary will be reliant on information flows and processes of third parties means that it has in any way delegated any of its functions to those third parties.

Assuming the question relates to the actual *delegation* of safekeeping duties in relation to "other assets" (rather than the reliance upon third parties for the provision of information etc to enable it to perform its duties) we would envisage that the depositary should be permitted to delegate its record-keeping and verification obligations to a third party if the AIF/AIFM so permits under the terms of the contract evidencing the appointment of the depositary and subject to the fact that despite such delegation the depositary would remain responsible for the performance of the functions under Article 21(8)(b).

In relation to such delegation, the depositary will be subject to the requirements of paragraph 11 of Article 21.

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?

In case (i) the assets could be transferred without the involvement of the depositary. In cases (ii) and (iii), in the absence of fraud, this is not the case.

Q37:
To what extent would it be possible / desirable to require prime brokers to provide daily reports as requested under the current FSA rules?
The FSA Rule requirements (under Chapter 9 of the FSA's Client Assets Sourcebook) impose a regulatory obligation on those prime brokerage firms which are subject to the FSA's rules to *make available* daily reports to their clients. In AIMA's view, these provisions are sensible and can provide the AIF/AIFM with useful up-to-date information on the status of their assets and, in particular, the extent to which they have been "rehypothecated".

However, that said, we are not sure to what extent (if at all) the Request for Advice calls for ESMA to give technical advice on this point and indeed we doubt to what extent there is actually any authority in the Directive to impose obligations on prime brokers as such. In any event, if the idea were to be pursued further (perhaps using the UK FSA rules as a model) we believe it would require a more detailed consultation than is provided by Q37.

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?

The Level 1 requirement in Article 21(8)(b)(i) is to maintain a record of all "other assets" for which it is satisfied that the AIF (or AIFM acting on behalf of the AIF) holds "ownership". Article 21(8)(b)(ii) provides that this record shall be kept up to date. As the first sentence of Box 81 makes clear, the depositary is reliant upon information from the AIFM (and, where necessary, from third parties).

As regards Option 1, we do not believe that sub-paragraph (i) and its requirement for *ex ante* notification is likely to be workable in many, if any, circumstances. Given that, we are not clear why it is presented as an alternative to the requirement in sub-paragraph (ii) for *ex post* access to documentary evidence on a timely basis which is far more practicable.

AIMA does not believe that there is a case for Option 2.

First, we do not believe that the ownership verification and record keeping requirements in Article 21(8)(b) (which to our mind at the very least *implies* an *ex post facto* exercise) can be read as requiring that "real time" mirroring of positions on an intra-day basis must take place.

Second, requiring the depositary to "mirror" all transactions in a "position keeping record" would in our view simply be unworkable in practice (except, perhaps, in the case of those AIF which trade on a low-frequency basis (e.g. a real estate fund), where the AIFM provides relevant information promptly). While it is possible that *some* depositaries may have, or be granted, access to real-time trading data, it is likely that many will not.

Furthermore, in the case of those AIF with high-volume trading strategies, a huge number of transactions will be entered into on an intra-day basis and many assets will be bought and sold in the same day, with many netted to zero at each close. Requiring a depositary to "mirror" such a process and maintain a real-time position record (if it could be achieved at all) would be disproportionately burdensome, highly expensive and unlikely to deliver any discernible benefits. There appears to be little point in having to verify the ownership of an asset bought in the morning and sold in the afternoon. Even if "mirroring" were feasible in practice it would be duplicative: as both the AIFM and (in the case of a hedge fund at least) the administrator will keep a complete record of all of the AIF's transactions.

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

It is unclear what ESMA means by "*underlying* assets" in this context. If it means, for instance, the assets underlying a collective investment scheme into which the AIF invests, then clearly the depositary should not be required to look at these. The ownership of the underlying assets is relevant to the *value* of the asset held by the AIF, not its *ownership* of that asset.

If the question is instead getting at the *level* of due diligence a depositary should carry out in order to verify ownership of non-custody assets held *directly* by the AIF, then it is inadvisable to be too prescriptive about this. Many different types of assets may fall within the definition of "other assets" and it is important that the technical advice recognises that in many cases it will be impossible to treat such assets in the same way as one would for the types of custody assets covered by Article 21(8)(a). Such "other assets" may include (amongst others): real property interests, derivative contracts, units or shares in collective investment undertakings not settled through a designated Securities Finality Directive securities settlement system, long-term insurance policies, high-value tangible assets (such as paintings, wine, livestock etc).

It will be impossible to prescribe a single, homogenous approach to the verification of ownership of such assets. In some cases, the depositary may have difficulty in obtaining reliable evidence of title and therefore "verification of ownership" needs to be understood against that background. Also, as we have mentioned before, the AIFM may (for instance, in the context of real estate funds) acquire property on the basis of a number of factors, including impaired legal title where evidence of title is more a matter for the AIFM than the depositary.

AIMA therefore believes that "ownership" should not be regarded as full and unencumbered title in all cases.

3.3.9 Oversight duties – general requirements (Box 82)

AIMA is in agreement with the sentiments expressed in Paragraph 48 of Section V.III. Specifically, it is our view that the provisions of Article 21 (9) (as with the provisions of Article 21 (7)) impose a general duty on the depositary to "*set up procedures and processes which are proportionate to the estimated risks*". That would entail an assessment of the risks facing the AIF in question.

It is also agreed that the second general principle described in Paragraph 49 should have some application. In order to discharge a primary obligation of ensuring appropriate and effective procedures are in place in respect of the areas listed in Article 21(9), the depositary must be able to assess the efficacy of the procedures in place. That would, of necessity, include the need for ex post *verifications* (on a sample basis) of the outcomes generated by the procedures being employed. It does not, however, require ex post "*controls*", which would again imply a "policing" role for the depositary not supported by the Level 1 text. See further below. We also agree that a depositary should have a clear and comprehensive escalation procedure where it believes that the procedures then in place are inadequate or in need of updating, or have been breached.

Notwithstanding the above, it is important to note that the Level 1 text does not oblige a depositary to undertake primary verification of every matter described in Article 21(9). Assuming that suitable procedures have been implemented as a result of the depositary's oversight, the depositary's duties have been discharged. Therefore, whilst the depositary must have (and use) information and reporting powers, those should not be extended so as to put the depositary in a role requiring ongoing, detailed reporting better done at the level of the AIFM, valuer or other service provider.

Two further points here:

- First, it would greatly aid efficiency if verification/monitoring requirements permitted the use, where possible, of existing audit, compliance or other materials already produced by the AIF/AIFM for other purposes. The more it is possible to achieve this, the more efficient the implementation of these requirements will be.

- Second, in order that all industry participants can have certainty as to the verification role proposed, it will be important to have sufficient clarity as to what the " obligations pursuant to Article 21 (9)" comprise. These clear requirements can then be replicated in the depositary agreement and met by the provision of information which, as above, may already exist for other purposes.

3.3.10 Clarifications of the depositary's oversight duties (Box 83)

As above, the depositary should not be required systematically to police the AIF/AIFM's operations, and this wording would appear to be consistent with that approach requiring as it does the depositary to monitor procedures.

Specifically in respect of subscriptions and redemptions, it should be noted that the depositary is unlikely to have primary oversight of this process, that being vested instead in the AIF's administrator. On this basis, therefore, the contractual arrangements between the depositary, the AIF, the AIFM and the relevant administrator must allow the depositary sufficient information/access powers to ensure the proper discharge of its general oversight duties under Article 21 (9).

3.3.11 Clarifications of the depositary's oversight duties (Box 84)

The depositary's role is not to duplicate that of the valuer under Article 19. A depositary should be able to place considerable reliance on the fact that an independent valuer has been appointed or that, where there is no independent external valuer, that valuation can be required where necessary.

In AIMA's view, it would be disproportionate to require any additional valuation involvement by the depositary given the role played by the independent valuer. It would, however, be proportionate to require the depositary to verify the existence of processes and procedures in respect of valuations, those processes or procedures being appropriate to the assets held by the AIF. Given the diversity of AIFs in existence, it is submitted that what is appropriate in terms of procedures should not be subject to overly prescriptive Level 2 measures. In particular, given the centrality of the valuation process to AIFM fees in a hedge fund context, the AIFM should not be required to determine the most suitable

valuation processes, but rather this should be settled between the AIF board and the investors at the point of subscription, having regard to the type of assets concerned.

We believe the following amendments should be made to the text of Box 84:

- in paragraph 2, the words "effectively implemented" should be deleted;
- in paragraph 4, the notification should be made to the AIF as well as the AIFM.

3.3.12 Clarifications of the depositary's oversight duties (Box 85)

A depositary's duty in respect of ensuring compliance with applicable law or the AIF rules or constitution should be discharged if there are suitable procedures in place ensuring the identification and rectification of any potential breaches.

In common with other comments throughout our response, we are firmly of the view that it is not appropriate, nor does the Level 1 text require, the depositary to act to police the AIFM's compliance. Rather, the depositary is obliged to ensure that suitable procedures exist and are maintained.

In the context of compliance with law/AIF rules, we would point out in particular that the depositary has no option but to settle trades made by the AIFM on a timely basis in accordance with contractual obligations. Further, it is not for the depositary to make any qualitative assessment of any particular trades, and it is market practice that trades are not reviewed by the depositary on a pre-settlement basis.

Finally, any oversight procedures in respect of AIFM instructions are not (and cannot practically be) carried out in advance of payment.

We consider that the following amendments (shown in underlining) should be made to the text of Box 85:

"**Duties related to the carrying out of the AIFM's instructions (c)**

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

1. **ensure that the AIF/AIFM has in place** appropriate procedures to **ensure their respective** compliance with applicable law and regulation, as well as with the AIF's rules and instruments of incorporation. In particular, the depositary should monitor **(on a sampling basis)** compliance of the AIF with investment restrictions and leverage limits defined in the AIF's offering documents. Those procedures should be proportionate to the nature, scale and complexity of the AIF.

2. **ensure that the AIF** and **AIFM have in place** an escalation procedure **to deal effectively with situations** where the AIF has breached one of the limits or restrictions referred to under §1. "

3.3.13 Clarifications of the depositary's oversight duties (Box 86)

As regards ensuring that consideration is remitted to the AIF within "usual" time limits, AIMA believes that Article 21(9)(d) would require the depositary to take account of controls and procedures in relation to some or all of the following areas:

- timeliness of the receipt of investment trades;
- failed trades;
- outstanding receivable controls and procedures in relation to items included in the NAV;
- dividend/corporate action procedures and entitlements;
- cash and asset reconciliations; and
- receipt of consideration for subscriptions.

As to AIMA's preferred option, please see Question 45, below.

3.3.14 Clarifications of the depositary's oversight duties (Box 87)

We do not have any comments in addition to our responses to the question below.

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?

Advice on oversight will have a very significant impact on these relationships. In our view it is imperative both that there be clarity as to the depositary's obligation vis-à-vis AIFs, AIFMs and their service providers, and there be as little duplication and inefficiency imposed, consistent with the proper implementation of the Level 1 text. The Level 1 text sets depositary obligations in terms of procuring that appropriate procedures and controls are in place. Therefore, whilst the depositary will not be directly responsible for "micro" level oversight of the activities of the various participants, it will require information/reporting. In terms of defective or absent information, clarity should also be provided as to liability - the depositary can only monitor the suitability and effectiveness of procedures if it is provided with accurate information, and an absence of such information should not result in a breach by the depositary.

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

We are unclear as to the meaning of this. We are not aware of circumstances in which the depositary would be "designated" to issue shares of an AIF. The issue of shares in an AIF is a matter for the AIF in conjunction with its administrator (particularly in the context of open-ended funds). There is no role for the depositary in the process, except as regards the receipt of subscription proceeds from successful applicants for shares and its oversight duty under Article 21(9)(a).

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?

Currently, the management of subscription arrangements would be somewhat removed from the depositary function. Subscription monies are generally received from prospective investors into a specific account (specified on the relevant application form). That subscription account may be an account for receiving subscription monies for a single fund, or an omnibus account for subscription monies received for a number of AIFs. Responsibility for performing reconciliations on subscription accounts and processing of subscription applications generally is likely the responsibility of either the AIFM or, more frequently, an administrator appointed by the AIF on its behalf. Only once the administrator has completed the investor acceptance process would monies be transferred from the subscription account into the other account of the AIF for deployment in accordance with the investment strategy.

Given the obligations set out in Article 21(9)(a), the depositary's role in this process would be to ensuring that appropriate investor acceptance and reconciliation procedures are in place.

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

We absolutely agree with ESMA's comments in paragraph 56 of its explanatory text: we can see no justification for arguing that the obligation in §2 of Box 83 extends beyond the sales of units or shares by the AIF or the AIFMD and captures secondary market activities as well.

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.

Please see response under Box 85 above.

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

AIMA prefers Option 1.

We believe that the approach proposed under Option 2 goes significantly beyond the scope of the requirement under Article 21(9)(d). The depositary is obliged to ensure that procedures are in place to enable the consideration to be remitted to the AIF within the "usual" time frame. Provided the depositary has ensured that appropriate procedures for handling consideration are in place, there is nothing in Article 21 (9) (d) which could be read so as to require the depositary to actually police the receipt of consideration by the AIF. Indeed, it is singularly poorly placed to do so as it will be the AIFM who has entered into the particular transaction with the relevant counterparty and is therefore best placed to know when and how consideration is due to be remitted (and therefore to police its receipt).

3.3.15 Due Diligence Requirements (Box 88)

We strongly support ESMA's proposal not to develop a "comprehensive template of evaluation, selection, review and monitoring criteria", as suggested by the Commission.

We further support the distinction made in ESMA's advice between delegation of custody of financial instruments in respect of which the custody obligation applies, and safe-keeping of other assets.

As a general point, we agree with ESMA's description of the ongoing monitoring requirement in paragraph 8 of the Explanatory Text to Box 88. Monitoring should consist of verifying certain matters, by means of appropriate checks and oversight; it should not require active policing or audit by the depositary. Accordingly, the depositary should not be subject to an obligation (via its monitoring) to "ensure" particular circumstances exist or protections are achieved. Its monitoring of delegates can only mitigate as far as possible (but not remove) the risks of delegation.

<u>Background</u>

The procedures for a depositary's selection, appointment and ongoing review and monitoring of a third party under Article 21(11)(c) should generally comprise those procedures which are reasonably necessary in order for the depositary to have complied with its obligations under Article 21(11)(d). Under Article 21(11)(d) a depositary is required to ensure that the relevant third party meets (and continues to meet) numerous standards, which necessarily will form a very significant part of the depositary's (i) due diligence on that third party prior to its appointment and (ii) ongoing monitoring of that third party.

Those requirements include ensuring (where relevant) that the third party:

- has adequate and proportionate structures and expertise;
- is subject to effective prudential regulation and supervision;
- is subject to external periodic audit;
- segregates the assets of the depositary's clients from its own assets from the assets of the depositary;
- does not use assets without prior consent of the relevant AIF or AIFM; and
- complies with the general obligations and prohibitions in Article 21(7) and Article 21(9).

The requirements relating to (i) effective prudential regulation and supervision and (ii) segregation of assets should apply only to the extent such requirements apply in the jurisdiction in which the assets are to be held. Recognition was given to the fact that the same standards may not be capable of being applied in all jurisdictions in the MiFID implementing measures (see, for example, Chapter II, Section 3 of Directive 2006/73/EC). These requirements are both appropriate and practical.

The general rule should therefore be that if a depositary has undertaken sufficient due diligence in respect of a third party (whether prior to its appointment or on an ongoing basis) in order to satisfy its obligations under Article 21(11)(d), then that due diligence should also be sufficient for the purposes of Article 21(11)(c).

It will be important to ensure that any due diligence requirements placed upon a depositary by virtue of Article 21(11) are broadly consistent with (i) international standards placed upon depositaries and custodians in other jurisdictions, and (ii) European jurisprudence in other areas, such as MiFID. (See, for example, Chapter II, Section 3 of 2006/73/EC.)

Finally, where a depositary is determining whether its due diligence requirements with regard to a third party have been satisfied, the depositary should be able to take into account any specific instruction or demand by the AIF or the AIFM that the depositary appoint or place financial instruments with that particular third party.

In our previous submissions, we argued that a list of criteria would have merit to the extent that it is acknowledged that: (i) the criteria are non-exhaustive; (ii) some of the specified criteria may be less relevant than others in any given case; and (iii) some of the specified criteria may not be relevant at all in any given case.

In those submissions we suggested that factors that may be relevant where a depositary is exercising its due diligence duties might include some or all of the following:

- whether, to what extent and by whom the third party is regulated;

- the depositary's experience (if any) of the third party's performance of services to the depositary;

- the arrangements which are or will be made by the third party for the holding of assets;

- the expertise and market reputation of the third party;

- in the case of assets held by a third party in a "third country", relevant legal requirements or market practices regarding the use of particular sub-depositaries;

- the extent to which assets held by the third party will be subject to reasonable care, based on the standards applicable to depositories in the relevant market, after considering all relevant factors including (to the extent applicable or relevant):

- the third party's practices, procedures and internal controls relevant to the tasks being delegated;
- whether the third party has the requisite financial strength to provide reasonable care for assets;
- the third party's general reputation and standing; and
- whether the depositary (or the AIF, where relevant) will have jurisdiction over and be able to enforce judgments against the third party (such as by virtue of relevant offices or consent to service of process); and
- whether the AIF or the AIFM has specifically requested or demanded that the depositary appoint or place financial instruments with that third party.

<u>Suggested amendments to Box 88 text</u>

We set out below a number of drafting suggestions in relation to Box 88:

- paragraph 1(a)(i) is very broadly drafted, and should be restricted to require the depositary to "carry out an assessment of the regulatory and legal framework governing the sub-custodian, with

a view to determining the key risks associated with such framework (including the potential implications of the insolvency of the sub-custodian)";

- we would suggest rewording paragraph 1(a)(ii) as follows (which also incorporates the text in paragraph 1(a)(iv) which can therefore be deleted): "carry out an assessment of whether the sub-custodian's internal procedures and controls (including its operational and technological capabilities) adequately protect the financial instruments it holds in custody". (Note: the depositary should not be expected to monitor practical compliance by the sub-custodian with these procedures and controls);

- for clarity, we would suggest replacing the reference to "renown" in paragraph (1)(a)(iii) with "reputation". The purpose of the assessment requirement by this paragraph could also be brought out more clearly, as follows: "carry out an assessment of the sub-custodian's financial strength and reputation, in the context of its suitability to perform the tasks delegated to it";

- the depositary's ongoing monitoring under paragraph (b) should "aim to ensure" the sub-custodian's continued compliance;

- paragraph (b)(i) could be clarified to provide that the depositary should "monitor the adequacy of the sub-custodian's performance of the tasks delegated to it and its compliance with standards imposed under the contract between the depositary and the sub-custodian";

- in paragraph (b)(ii), we believe that the depositary's obligation should be to "monitor the sub-custodian with a view to enabling the depositary to determine whether the sub-custodian exercises reasonable care in the performance of its custody tasks and particularly that it effectively segregates the financial instruments in line with the requirements set out in Box 89" (In this regard, we have assumed that the cross-reference to Box 16 should be a reference to Box 89 and that the reference to "financial instruments assets" should be a reference to "financial instruments" only.);

- in our view, the depositary's obligation under paragraph (b)(iii) should essentially be to revisit the assessments carried out under (a)(i) and (a)(iii) and to notify any material changes to the AIF/AIFM.

Finally, there should not be an automatic obligation on the depositary to terminate a sub-custody agreement in the event of non-compliance by the sub-custodian; this may not, in every case, be in the AIF/investors' best interests. As an alternative, we would suggest that the depositary be required to "take such measures, including terminating the contract, as are in the best interests of the AIF and its investors where the delegate no longer complies with the requirements".

3.3.16 Segregation obligation for third parties to which depositaries have delegated part or all of their safekeeping functions (based on Article 16 of Directive 2006/73/EC implementing the MiFID Directive) (Box 89)

Background

Under Article 21(11)(d)(iv) one of the preconditions to delegation by the depositary is that the depositary ensures, on an ongoing basis, that the delegate segregates the depositary's client assets from its own assets and those of the depositary.

AIMA is pleased to see that ESMA has acknowledged in its commentary that these provisions are intended to allow the depositary's client assets to be held by sub-custodians in a pooled "omnibus" account, as is general practice currently (provided that the same account does not also hold the sub-custodian's own assets). AIMA further understands this segregation requirement not to apply at the level of accounts held by the sub-custodian with third parties who would not themselves be a sub-custodian for the purposes of the Directive (such as a central securities depositary). We consider that both these points should be made explicit in the wording of the criteria in Box 89.

Suggested amendments

We have the following suggestions for amending the text in Box 89:

1. We do not have particular issues with the items listed in paragraph 1 of Box 89, except that we consider it should be more expressly stated in paragraphs (d) and (e) that the requirement for segregation of financial instruments held in custody and cash relates to such instruments and cash belonging to the relevant sub-custodian but that in each case omnibus accounts and/or nominee arrangements may be used in relation to client assets (provided in each case that the same account does not also hold the sub-custodian's own assets);
2. We consider that the first sentence of paragraph 2 should be amended to read: "Where the depositary has delegated its custody functions, it must monitor the sub-custodian with the aim of ensuring the segregation obligations imposed on the sub-custodian are complied with and that such obligations are designed to protect the financial instruments belonging to its clients from an insolvency of that sub-custodian";

3. We consider the first part of the second sentence of paragraph 2 should be amended to read: "If, for any legal or regulatory reason, such segregation of financial instruments belonging to its clients is either not achievable in relation to a particular sub-custodian or such segregation would be unlikely to be effective in providing protection in the event of the insolvency of the relevant sub-custodian, the depositary should assess …etc."

Finally, we suggest that the depositary should be required to incorporate into the sub-custody agreement requirements to the effect of those listed in paragraph 1, as well as the obligation in paragraph 2 that where such arrangements would not be practicable in a particular jurisdiction, the depositary should consider whether there are any additional or alternative safeguards to protect against the sub-custodian's insolvency risk that should be required.

Q46:
What alternative or additional measures to segregation could be put in place to en-sure 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.

In terms of additional or alternative measures to segregation, AIMA considers a responsible global custody network would typically obtain local "ring fence" opinions from counsel in the relevant jurisdiction and, depending on the issues highlighted, would adjust its due diligence and monitoring procedures accordingly in terms of establishing the adequacy of the local sub-custodians systems and procedures and the regular reconciliation of its accounts. More extreme measures that might be considered could include, for example, increasing the frequency and accuracy of reconciliations, the use of buffers, prohibitions on temporary deficits in client assets or agreeing arrangements prohibiting the use of a debit balance for one client to offset a credit balance for another. However, where such additional measures might be unduly burdensome or significantly increase costs, AIMA considers that an AIF should be able to elect to forgo such additional protections, subject to appropriate risk disclosure being made to its prospective investors.

It is important to note that segregation itself does not "insolvency proof" client assets, though it is obviously very helpful in the event of an insolvency. Segregation does not affect property rights over the assets, nor prevent client assets going missing as a result of fraud or insolvency, but it is important in terms of distinguishing from an evidential point of view where an institution is acting as agent or trustee as opposed to investing as principal. However, as concluded by IOSCO in their March 2011 Survey of Regimes for the Protection, Distribution and/or Transfer of Client Assets: "Segregation of Client Assets provides an effective framework for [Client Asset] identification. Segregation, particularly when coupled with reconciliation, also discourages fraud or misuse of Client Assets."

One of our members has carried out due diligence on 97 jurisdictions, which has indicated that in each of those jurisdictions market segregation between the local custodian and the global custodian is

effective and securities can be recovered, notwithstanding the local custodian's bankruptcy, provided that certain basic conditions are met, normally that securities are segregated in the books and records of the local custodian by way of separate accounts or physical segregation.

In terms of the requirement for assets to be identifiable as belonging to clients of a particular depositary, the same member has identified a number of markets where the registered holder of the securities in the local custodian's books and records is viewed as the owner of the securities and the concept of beneficial ownership is not recognised. Examples include Argentina, Indonesia, Mexico, Pakistan, Russia and Thailand. For example, in the Russian market, non-Russian global custodians can hold customer securities in the following manners:

(1) The global custodian can open an omnibus account with a Russian depositary bank. As the registered holder of the securities, the global custodian is viewed as owner of the securities as a matter of Russian law.

(2) The global custodian can introduce its clients to a local Russian depositary bank, which may be affiliated or unaffiliated with the global custodian. The Russian depositary bank must adopt each individual client in order to open a segregated account in the name of each client. Each client is required to enter into an agreement with the Russian depositary bank and go through the account opening process. In other words, the global custodian steps out of the holding pattern and the AIF has a direct relationship with the local Russian depositary bank.

The wording of the Directive should not be construed narrowly in order to prevent the continuation of these arrangements.

3.4 The depositary's liability regime (section V.IV)

3.4.1 Summary

As regards the definition of loss (Box 90):

- The Conditions are unclear as currently drafted:
    - Condition (a) – stated right of ownership – should either refer to the financial instruments themselves being lost, or should refer to the AIF's right of ownership. Otherwise there is a danger that *any* claimed right of ownership is captured by Condition (a).
    - If Condition (a) refers only to the AIF's right of ownership, Condition (b) becomes unnecessary.
    - Condition (c) – AIF is permanently unable to dispose of the financial instrument – requires further explanation. Local law/similar could result in an inability to dispose but this does not mean that the financial instrument has been "lost" in any ordinary sense of the word. Additional examples of what should not constitute a loss (e.g., enforcement of a security interest) should be provided.

As regards "external events" (Box 91):

- Acts and omissions of an unaffiliated sub-custodian must be presumed to be "external".
- The consequences of unaffiliated sub-custodians' acts and omissions being considered "internal" (as in ESMA's draft advice) cannot be overstated:
    - Capital costs would increase significantly and systemic risk would also increase accordingly (market dominated by fewer depositaries);
    - As a result of increased capital costs, AIFs would likely face inflated fees from depositaries – possibly more than double the current level of fees; and

- Ultimately, investors would suffer from lower returns, putting the European alternative funds industry at a disadvantage.

As regards the ability of a depositary to discharge liability (Q.52):

- The benefit of a depositary being able to discharge its liability should not be overestimated. That is why, in AIMA's view, it is crucial that the acts and omissions of unaffiliated sub-custodians be presumed to be "external" events.

- Many sub-custodians will be unwilling to assume liability over and above their own fraud (and negligence).

- Even if sub-custodians are willing to assume liability, there are potentially significant difficulties with transferring liability. AIFs/AIFMs may have to directly enter into many agreements with many sub-custodians. Laws permitting third party rights (i.e., allowing the AIF to directly take action against a sub-custodian despite not being party to the agreement between the depositary and the sub-custodian) are not universal.

AIMA strongly supports Option 2, set out in Box 92, whereby the requirement for an objective reason is fulfilled where the AIF/AIFM has explicitly agreed that the transfer of liability to a sub-custodian is permitted. It has the virtue of clarity and objectivity and is also more likely to cover all circumstances in which the AIFM and the depositary might, quite properly, agree that the depositary ought to be able to discharge its liability. We agree with the comments made in paragraph 44 of the explanatory text to the effect that there are other safeguards within AIFMD as conditions for the discharge of the depositary's liability and that these are sufficiently protective. As ESMA says, it is of the utmost importance to have workable criteria to define the objective reason for a contractual discharge.

3.4.2 Definition of loss (Box 90)

AIMA considers the drafting of the Conditions to be unclear.

Conditions (a) and (b)

On its face, Condition (a) includes any stated right of ownership (whether the AIF's or that of a third party, and whether completely unfounded or not). If Condition (a) is to refer to a right of ownership, it must surely be that of the AIF (*i.e.*, it should be clear that rights claimed by third parties are entirely irrelevant).

It appears to AIMA that there are two ways of approaching Condition (a). Either:

- make Condition (a) reflect ESMA's intention (as explained in paragraph 14 of Section V.IV of the Consultation Paper). That is: Condition (a) is that the financial instruments themselves permanently cease to exist or never existed. If this approach is taken, then Condition (b) could remain in its current form; or

- leave the drafting of Condition (a) as it is, but make it clear that the only relevant right of ownership is the AIF's. But if this approach is taken, Condition (b) can be deleted because it is already dealt with by Condition (a).

Condition (c)

Condition (c) currently relates to the AIF's permanent inability to dispose of the financial instruments.

But a "permanent inability to dispose of a financial instrument" will not always mean that the financial instrument has been "lost" in any ordinary sense of the word. The financial instrument may still exist, the AIF may still own it, and yet it may be thought that the instrument is incapable of being "disposed of" due to changes in local law or other restrictions attaching to the instrument. This is not (and ESMA's advice should make it clear that it is not) a "loss" of the financial instrument.

As explained below, AIMA does not believe that it would be reasonable to treat this as a loss on the basis that a depositary might be able to discharge its liability in those circumstances.

In addition, in the case of loss due to the insolvency of a sub-custodian we note ESMA's suggestion that a loss must be recorded as soon as there is certainty that part of the financial instrument is lost. In those circumstances, the liability of the depositary must be the amount actually lost (*i.e.*, a partial loss should not be deemed to be an automatic loss of the entire financial instrument).

Finally, AIMA considers that ESMA should include in Box 90 – for the avoidance of doubt - another explicit example of a scenario that should not constitute a "loss": any enforcement of a security interest by a party benefiting from a security. This could clearly constitute permanent deprivation by the AIF of ownership of a relevant financial instrument (for example through being liquidated in the context of the security being enforced).

3.4.3 Definition of 'external event beyond the depositary's reasonable control, the consequences of which were unavoidable despite all reasonable efforts to the contrary' (Box 91)

Meaning of "external"

AIMA considers that the draft advice provided by ESMA on the meaning of "external" amounts to an interpretation – even a *de facto* amendment - of the Level 1 text. Interpreting the Level 1 text is a matter for the courts. Amending the Level 1 text is, of course, a matter for legislators.

The result of ESMA's approach would be a regime that is far more prescriptive than the Level 1 text itself supports. The interpretation that has been taken of Article 21(12) of the Level 1 text, taking into account Article 21(13), is that the acts and omissions of any appointed sub-custodian are automatically deemed not to be "external events". This is not what the Level 1 text says.

Article 21(13) simply says that a depositary's liability shall *not be affected* by any delegation referred to in paragraph 11. This means that the depositary does not escape potential liability for loss simply by delegating. Any liability for loss by the depositary, or by a third party to whom it has delegated, should therefore be assessed in accordance with Article 21(12).

The Level 1 text *does not say* (or mean) that – adopting ESMA's three-step approach as set out in Figure 1 – acts or omissions of a sub-custodian by definition can never be "external" events and therefore must be internal. AIMA profoundly disagrees with this interpretation, the effect of which would make the depositary strictly liable for all acts and omissions of any sub-custodian, regardless of the degree of control which the depositary can meaningfully exert.

AIMA's view is that ESMA's approach goes well beyond its mandate to provide the Commission with technical guidance.

It is a practical reality that many depositaries will need to delegate to many unaffiliated sub-custodians over whom the depositaries have no control or influence at all. A natural interpretation of the word "external" would, in AIMA's view, be one that recognises that the acts and omissions of such sub-custodians are necessarily "external". That would mean that the depositary's liability for the acts or omissions of unaffiliated sub-custodians will be determined by the remaining two steps of ESMA's liability flow chart. While we think it still runs counter to the natural interpretation, we consider that it would be reasonable for ESMA to advise that there should be a presumption that the acts and omissions of *affiliated* sub-custodians are "internal" (a presumption that could be rebutted by evidence in the particular case).

This is now considered in more detail.

Level 1 text – what it says

Article 21(12) of the level 1 text is comprised of three paragraphs: the first paragraph contains a general statement of liability; the second paragraph contains detail of a consequence of liability, as well as a carve-out from liability; and the third paragraph contains a further consequence of liability. So, in summary:

Paragraph 1: General statement of liability.

Paragraph 2, sentence 1: Detail of a consequence of liability.

Paragraph 2, sentence 2: A carve-out from liability.

Paragraph 3: Detail of a further consequence of liability.

That statement of liability includes liability of a depositary both for losses by it, and for losses by third parties to whom custody has been delegated. It is a broad statement of liability because it is followed by a carve-out from liability.

The carve-out from liability contained in paragraph 2 is an "external event" beyond the depositary's reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary.

The carve-out in its entirety must be relevant for both (i) losses by the depositary; ***and*** (ii) losses by a third party to whom custody has been delegated.

ESMA's suggested flowchart (Figure 1)

Connected to this, ESMA intends to break the liability carve-out into three distinct steps, as depicted in Figure 1: (1) Is the event external? (2) Is the event beyond [the depositary's] reasonable control? (3) Could the consequences have been avoided with reasonable efforts?

This is a reductive approach; each step further reduces the circumstances in which a depositary can avoid liability. Step 1 will have the largest "pool" of events, Step 2 reduces that "pool" and Step 3 reduces that "pool" yet further.

ESMA's interpretation of the Level 1 text (sub-custodians' acts and omissions cannot be "external") effectively means that the "pool" is extraordinarily narrowed by Step 1. The result is that Steps 2 and 3 become close to redundant. This cannot have been the intention of legislators.

Furthermore, while AIMA agrees with ESMA that there are three limbs to the discharge of liability provision in Article 21(12), we believe that the approach set out in Figure 1 is overly dogmatic, especially if the advice concludes that any events or omissions on the part of a sub-custodian are inherently "internal".

An "on its face" interpretation

More generally, it is hard to see how any reasonable interpretation of the word "external" on its face could be taken to include acts and omissions of any third parties, whether affiliated or unaffiliated. A natural, or dictionary, interpretation of the word "external" when applied to a depositary would be anything occurring outside of the activities of the depositary itself – *i.e.*, the legal entity.

In general, following on from the natural interpretation, our understanding of the concept of "external" in these types of provisions in an EU context (i.e., provisions relating to a discharge of a liability) is that it refers to an event that is beyond the control of the relevant party. Thus, under such provisions, a party is responsible for persons and things over which *it is deemed to have control*.

The result is that acts or omissions which take place within the legal entity of the depositary, including those of its employees, are necessarily "internal". This "deemed control" analysis highlights the fact that

there is a relationship between the first two limbs of the discharge of liability provision in Article 21(12). The deconstructed approach in Figure 1 does not allow for that relationship – particularly if unaffiliated sub-custodians' acts and omissions are necessarily "internal".

AIMA's view is that it would be both disproportionate and divorced from reality to deem that the depositary will inherently have control over all of its sub-custodians.

On the "deemed control" analysis, which AIMA believes to be the correct one, AIMA can however see an argument for mandating that acts and omissions of an affiliated sub-custodian ought to be considered "internal". The justification would be that, because the depositary has selected a sub-custodian within its own group, it is right and proper that it should be deemed to have control over the sub-custodian. That is: events that take place within affiliated sub-custodians could be regarded as being within the reasonable control of the depositary. AIMA's view is that this is a more sustainable change to the natural meaning of the word "external" than deeming that the depositary has control over all of its sub-custodians.

AIMA emphasises that, even with a natural interpretation of the word "external" that AIMA views as essential, a depositary will still be liable for the acts and omissions of its unaffiliated sub-custodians unless it is able to discharge the burden of proof in relation to the remaining Steps 2 and 3 in ESMA's flow chart. This, in AIMA's view, is a greater incentive to the depositary to fulfil its due diligence obligations in respect of sub-custodians than would be the case by simply making the depositary strictly liable for them.

Indeed, the Level 1 text's requirement for detailed due diligence by a depositary when selecting sub-custodians can be seen as evidence that the legislators did <u>not</u> intend for a depositary to automatically be strictly liable for such sub-custodians.

<u>Consequences of flawed interpretation of word "external"</u>

If ESMA's proposed interpretation of the word "external" is taken forward and accepted by the Commission, not only would this in AIMA's view be contrary to the Level 1 text, but the practical result is likely to be highly counter-productive.

Capital costs to depositaries (further detailed below) would increase significantly, in a manner that would be highly detrimental – conceivably even fatal – to the European alternative funds industry. Those costs, which will probably be uninsurable, will have two clear effects:

- *First*, smaller and medium-sized depositaries would very likely be squeezed out of the market. The result would be a market dominated by a concentration of large firms who are prepared to take on the additional costs and risks involved. As stressed on page 36 of AIMA's previous submission of 14 January 2011, such a concentration will inevitably increase – not reduce - systemic risk, and will reduce the level of protection afforded to an AIF and their investors; and

- *Second*, a substantial portion of those increased costs would inevitably be ultimately borne by the AIF and investors in the AIF, in order for any depositary's business model to be feasible.

Each of those outcomes is extremely undesirable, is contrary to the spirit of the Level 1 text, and could have devastating repercussions for the European funds industry. Fees charged to AIFMs and AIFs by depositaries would increase drastically. That would result in lower returns for investors, and European products and managers being at a huge commercial disadvantage to non-EU equivalents. At worst, it could also result in relocation outside the EU of the alternative fund management industry.

Furthermore, making depositaries strictly liable in this way shifts the responsibility of depositaries from one of oversight of unaffiliated sub-custodians, to essentially underwriting the performance of such sub-custodians. The Level 1 text does not require or support such an outcome.

Finally, there is a risk that AIFMs may choose to invest in countries with less secure internal infrastructure, safe in the knowledge that the depositary will be liable for any losses. It is difficult to see why the burden of such risks (essentially chosen by AIFM) should be placed on depositaries.

Looking at it from another perspective, depositaries may simply refuse to provide custody services for assets issued in certain jurisdictions (for example, where they are perceived as high-risk) – thus effectively limiting certain investment strategies/activities of an AIFM, regardless of whether such limiting is in the interests of the AIF or its investors.

Condition 3 of ESMA's draft advice

This condition relates to an inability of the depositary to prevent the loss, "[d]espite rigorous and comprehensive due diligence". The language used in this condition is not the wording used in Article 21(12) and is not used elsewhere in the explanation of ESMA's draft advice on this point. AIMA is of the view that it is inappropriate.

The flow chart in Figure 1 indicates that Condition 3 is: "Could the consequences have been avoided with reasonable efforts", which we consider to be an acceptable paraphrase of the Level 1 text. Condition 3 should not "rewrite" the text of Level 1 or the burden of proof which the depositary will have to discharge if it is to rely on the discharge of liability.

Imposing a requirement of "rigorous and comprehensive due diligence" does not reflect the Level 1 text and could be read as requiring a depositary to go far beyond "reasonable efforts". The word "comprehensive", in particular, could be interpreted as meaning that a depositary would need to do all-encompassing due diligence, covering as wide a range of theoretical possibilities as may be conceived, regardless of how reasonable it might be to do so.

Immediately after Condition 3, there follows an explanation of where a depositary "could" be regarded as having made reasonable efforts to avoid a loss. In order for the explanation to have meaning, AIMA's view is that the word "could" should be replaced with the word "should" (*i.e.*, taking the three stated actions would amount to a 'safe harbour').

Finally, in respect of limb (c) of Condition 3, it would be helpful if, for the avoidance of doubt, ESMA could make it clear in its explanation that "appropriate actions" can only ever cover actions that are in the reasonable control of the depositary (and not, for example, actions that stray into the AIFM's territory of investment management decisions).

To reflect the comments we have made above, we believe that the text of Box 91 should read as follows:

> "**Definition of 'external event beyond the depositary's reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary'**
>
> The depositary will not be liable for the loss of financial instruments held in custody for itself or by a sub-custodian if it can demonstrate that all the following conditions are met:
>
> 1. The event which led to the loss did not occur as a result of an act or omission of the depositary or one of its affiliated sub-custodians to meet its obligations.
>
> 2. The event which led to the loss was beyond the depositary's reasonable control, *i.e.*, it could not have prevented its occurrence by reasonable efforts.
>
> 3. Despite all reasonable efforts to the contrary, the consequences of the event which led to the loss could not have been avoided.
>
> Subject to the requirements of 1 and 2 being fulfilled, the depositary or the sub-custodian should be regarded as having made…[*etc.*]"

3.4.4 Objective reasons for the depositary to contract a discharge (Box 92)

Preference for use of Option 2

AIMA's strong preference is for Option 2. It has the virtue of clarity and objectivity (in that it will be easy to evidence whether or not there has been a contractual agreement). It is also more likely to cover all circumstances in which the AIFM and the depositary might, quite properly, agree that the depositary ought to be able to discharge its liability. We agree with the comments made in paragraph 44 of the explanatory text to the effect that there are other safeguards within AIFMD as conditions for the discharge of the depositary's liability and that these are sufficiently protective. As ESMA says, it is of the utmost importance to have workable criteria to define the objective reason for a contractual discharge.

Why Option 1 is not workable

Our concern with Option 1 is that, when compared with Option 2, it lacks clarity, certainty and objectivity.

Paragraph 44 of the explanatory text clearly states that the Option 1 approach would require the depositary to *demonstrate* that that it either had to appoint a specific sub-custodian as a result of a legal requirement (etc) or that the delegation of the custody tasks to the sub-custodian is in the best interest of the AIF.

In our view, this means that Option 1 as drafted is subject to far too many imponderables and would introduce significant uncertainty as to the effectiveness of the discharge of liability and, indeed, whether it had been discharged at all. From ESMA's comments, It would appear not operate as a full discharge at the time of contract but instead only a "conditional" discharge, with a burden of proof falling on the depositary to show why it had no option but to delegate or that delegation was in the best interest of the AIF and its investors. This would be particularly onerous on the depositary and too easy for the AIFM/AIF to argue with the "benefit of hindsight" if the depositary had to show – in retrospect – that the discharge had been at all times in the best interests of the AIF and the investors.

The first limb of Option 1 is unclear. Further examples could be included of the circumstances in which a depositary "has no other option" but to delegate (such as "where it has no affiliated sub-custodian within the relevant jurisdiction, or where the AIF or (as the case may be) the AIFM has required that a particular sub-custodian be appointed") but even then we would be concerned about the lack of clarity.

The second limb of Option 1 is also unclear and uses a subjective criterion. While on its face, the second limb of Option 1 would be satisfied by an agreement having been reached to the effect that a discharge is in the best interests of the AIF and its investors, as mentioned above the explanation given in ESMA's draft advice states that the depositary would have to *demonstrate* that the discharge was objectively in the best interests of the AIF and its investors. We reiterate that such an approach would introduce significant uncertainty as to the effectiveness of the discharge of liability.

Our concern about imposing an obligation on the depositary to demonstrate the fulfilment of a subjective criterion is compounded by the fact that the standard of "best interests" is extremely high and could require an analysis of any number of factors of which the depositary might not be aware at the time of agreement to discharge.

Significant changes would have to be made to both to the text in the second limb of Option 1, and in the explanatory text, before the Option could be even be considered to be workable. At the very least, for instance, the standard of "best interests" would have to be changed to simply "interests", to reflect a more realistic standard and ESMA's explanatory text would have to be amended to make it clear that it would be sufficient that the depositary reasonably believed, at the time of agreement with the AIF/AIFM, that delegation was in the interests of the AIF and its investors. There should be no requirement for the depositary or the AIFM to demonstrate, objectively (whether prospectively or retrospectively), that the discharge was in the interests of the AIF or investors.

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?

Independent research commissioned by AIMA, based on estimates received from custodian/potential depositary respondents, suggests that the strict liability regime as proposed by ESMA (i.e. that the acts or omissions of all sub-custodians should be considered to be "internal events") could result in the industry facing increased costs at least 4-5 times greater than presently.

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

Below are suggested events that follow the current draft definition of "loss" proposed by ESMA in Box 90, although we have already expressed reservations about that definition (discussed above).

(a) a stated right of ownership is discovered to be unfounded because it either ceases to exist or never existed:

- Fraud resulting in the permanent loss of the financial instrument

(b) the AIF has been permanently deprived of its right of ownership over the financial instruments:

- Nationalisation of the issuer – the financial instruments of the issuer are nationalised, expropriated or are otherwise required to be transferred to any governmental agency, authority or entity.

(c) the AIF is permanently unable to directly or indirectly dispose of the financial instruments:

- Change in relevant law – e.g. due to the adoption of or change in any applicable law or regulation (including tax laws) it becomes illegal to hold, acquire or dispose of the financial instruments.
- In some cases, government action may result in "loss" – for example, where a government (or governmental institution or agency) has taken action which has had the effect of permanently and irretrievably preventing the transfer, sale or other disposition of the financial instruments.
- In some cases, national or international embargoes (i.e., a government (or government institution or agency) or an international organisation has announced a trade embargo affecting the ability to transfer, sell or dispose of the financial instruments) may be sufficiently permanent that the financial instruments can be considered "lost".
- Liquidation, dissolution or winding up of issuer – but, as ESMA rightly recognises, only where it becomes certain during (or at the end of) the insolvency process that the financial instruments are permanently and irretrievably lost.

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?

No. AIMA strongly supports this proposal, and considers that matters relating to local legislation are inherently "external". Local law is, of course, entirely outside the control or influence of the depositary. Changes in local law are also inherently unpredictable. AIMA cannot see any justification for any matter pertaining to local law being treated as an "internal" event.

This should not end at "local legislation", though. Precisely the same analysis applies to other 'local' law and equivalent, such as decisions and orders of competent courts, regulators and other governmental entities.

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

Set out below is a non-exhaustive list of examples of other events which should be presumed 'external':

- Acts or omissions of an unaffiliated sub-custodian.
- Any event, the occurrence of which might reasonably be considered to be part of the general risk of investing.
- Liquidation, dissolution or winding up of an issuer.
- National or international embargoes.
- Nationalization, strikes, devaluations or fluctuations, seizure, expropriation or other government actions, or other similar action by any governmental authority, de facto or de jure; or enactment, promulgation, imposition or enforcement by any such governmental authority of currency restrictions, exchange controls, levies or other charges affecting the financial instruments.
- Breakdown, failure, malfunction, error or interruption in the transmission of information caused by any machines, utilities or telecommunications systems.
- Any order or regulation of any banking or securities industry authority including changes in market rules and market conditions affecting the orderly execution or settlement of financial instruments transactions or affecting the value of financial instruments.
- Acts of war, terrorism, insurrection or revolution.

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?

As the proposed advice stands, the types of event that would qualify as "external" would be grossly limited.

As noted in our response to Box 91, the result is that Steps 2 and 3 of ESMA's flow chart in Figure 1 become close to redundant, which cannot have been the intention of legislators.

It is essential that acts and omissions of unaffiliated sub-custodians be presumed to constitute "external events" – and then Steps 2 and 3 of ESMA's flow chart in Figure 1 are no longer redundant, and make the test a real one: was the act or omission in question of the sub-custodian beyond the reasonable control of the depositary? If so, could the consequences have been avoided with reasonable efforts?

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?

AIMA considers that depositaries should not be strictly liable for the acts and omissions of unaffiliated sub-custodians. We have explained why, in our view, it is crucial that the acts and omissions of unaffiliated sub-custodians be treated as "external" events and why there is no justification under the level 1 text for automatically deeming them to be "internal events".

AIMA believes that many (if not most) sub-custodians will be unwilling to assume liability over and above their own fraud (and possibly negligence). Even if sub-custodians were willing to assume such full liability, the practical difficulties of such a transfer of liability could involve AIFs/AIFMs having to directly enter into agreements with many sub-custodians. Laws permitting third party rights (*i.e.*, overriding basic principles of privity of contract) are not universal.

A theoretical ability to transfer liability to sub-custodians may therefore be of relatively little value.

In summary, making unaffiliated sub-custodians' acts and omissions "internal", on the basis that depositaries might be able to transfer liability, will likely have the following result: depositaries will largely remain liable and will bear the risk of failures by unaffiliated sub-custodians.

The costs of such an outcome for AIFs, their investors and the European funds industry, as discussed above, will be significant and highly detrimental.

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 understand that ESMA's approach is, quite rightly, to understand Article 21(8) as meaning that, for funds investing in private equity or real estate assets, the assets do not constitute "financial instruments that can be held in custody" within the meaning of Article 21(8)(a).

Assuming that to be the case, the framework set out in the draft advice should be workable for such funds (it would clearly not be appropriate otherwise, since the private equity/real estate assets cannot be held in custody and so the assumptions underpinning the framework in ESMA's draft advice – that the assets are held in custody – cannot apply).

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 tailoring that is essential is already discussed above, *viz.*, (i) acts and omissions of unaffiliated sub-custodians must be presumed to be "external", and (ii) it must continue to be recognised that for funds investing in private equity or real estate assets, those assets are not "financial instruments that can be held in custody".

4 Possible implementing measures on methods for calculating the leverage of an AIF and the methods for calculating the exposure of an AIF (section VI)

4.1 Introduction

We note that the ESMA draft advice often takes up terms which are present in the CESR Guidelines on Risk Measurement and the Calculation of global Exposure and Counterparty Risk for UCITS. We would caution ESMA to simply take up the wording of the guidance and propose that wording to be included in binding legislation without any qualification. Second, it is surprising that in some areas, ESMA considers that a full policy alignment not only with the UCITS legislation but also guidance is necessary while in other extremely important areas such as the rejection of a VaR-based measure of leverage, ESMA significantly diverges from UCITS.

We strongly support the principle that there should be more than one measure of leverage. However, we believe that the AIFM should only be required to calculate one measure of leverage for the purposes of obtaining a common and comparable measure of leverage in order to monitor systemic risk. The AIFM should be free to choose which of the other methods is the most appropriate measure of leverage to the particular AIF for the purposes of setting the maximum leverage and reporting to investors.

We believe that only one method of leverage should be chosen to be calculated in a mandatory way and that the most appropriate method should be an adjusted Commitment/Gross Method. The adjustment should be mainly in the form of treating derivatives exposures in line with the treatment of derivatives under the Basel III regime which has recently proposed in the CRD IV package (please see below for a more detailed explanation). The fundamental reason for this policy should be to obtain a measure of leverage which is not only comparable across the AIF industry but across the different financial sectors. Only this method could give the ESRB a consistent picture of the build up of leverage in the financial system.

AIMA believes that the Advanced Method of calculation should be a self standing method which can be chosen without the need for an application or a notification to competent authorities. For the hedge fund industry, this so far appears to be the only meaningful measure of leverage in the draft ESMA advice and we believe it would be the predominant method of calculation of leverage chosen by hedge funds.

We would strongly recommend further consideration of the notion of relative or absolute VaR as a measures of leverage. These could be self standing methods or alternatives to the commitment method. We believe such VaR measures of leverage are fully compliant with the level 1 definition of leverage as they will capture all increase in exposure of an AIF. Although such exposure is measured using a 'top down' rather than a 'bottom up' approach, it nonetheless includes the effects of all underlying instruments and borrowing which lead to an increase in exposure and thus volatility. The European Central Bank has recognised VAR as a valuable measure of leverage, and noted in its paper *Hedge Funds and their Implications for Financial Stability*:

> "Accounting-based balance sheet measures of leverage [such as gross/net balance sheet leverage] fail to reflect the risk of the assets. Risk-based measures [such as VaR] alleviate this shortcoming by relating market risk to the capacity to absorb it."[2]

ESMA has argued that VaR measures do not perform well in stressed conditions. However, similar arguments could be made about a number of measures or instruments used for regulatory purposes across EU regulation. For example, we believe that the measure of leverage obtained by using the gross

[2] *Hedge Funds and their Implications for Financial Stability*, ECB, 2005, at page 30.

method does not perform even under normal conditions as it is more a measure of the fund's interconnectedness than leverage. We therefore believe that well-implemented VaR approaches will provide a more meaningful representation of a fund's leverage.

We strongly support the notion that exposures can be bounded by loss limits and that this idea should be incorporated in the notion of leverage.

We strongly recommend that the notion of gross leverage is not used because

- Leverage as defined in Article 4 of the AIFMD means any method which increases exposure of an AIFM but gross leverage is not an exposure. For example, a fund that simply traded exchange traded short term interest rate futures and options contracts in both the listed and the OTC markets might build a portfolio of derivative positions all referenced to exactly the same underlying contract. Many of these contracts will net or other contracts with there being no basis risk. A meaningful measure of leverage would allow this netting, but the gross measure does not.

- By reporting gross leverage calculated this way to regulators and investors, ESMA will be lending credence to a number which for many AIFs is actually meaningless. This will increase confusion among investors and reduce transparency – exactly the opposite of what should be the aim of the AIFMD.

- According to our understanding neither Basel III nor the new Commission proposal for Banking regulation use gross exposure to measure leverage. Indeed, Article 416(6) of the Commission CRD4 proposal clearly states that in determining the exposure value of derivatives, institutions must take into account the effects of contracts for novation and other netting arrangements (see Box below for information on CRD4).

This said, we agree that knowing the AIF's gross exposures could be important for competent authorities in the conduct of their supervisory duties since, as we have pointed out, gross exposure could serve as a very rough proxy for the AIF's interconnectedness. We believe that reporting gross exposures could be part of the obligations AIFMs have to meet under Article 24.

Proposal for an adjusted Gross/Commitment method:
We believe that one of the biggest problems associated with the calculation of leverage as proposed in the Gross and Commitment methods is that they would give a distorted picture of leverage in the alternative investment industry as opposed to the banking sector. As far as possible, leverage calculations which are carried out for the purpose of monitoring systemic risk should be as consistent across sectors as possible.

We would therefore propose to supplement the Gross/Commitment Methods with the treatment of derivatives exposures which is present in the proposed CRD4 package. This would essentially entail calculating the market value of derivatives and then imposing an add-on which is calculated as a percentage of the underlying notional exposure in accordance with the Mark-to-market Method introduced in Article 269 of the Commission proposal.

The Commission's proposal for CRD4 was published 20 July 2011

Article 416(6)

Institutions shall determine the exposure value of items listed in Annex II (essentially all derivatives) and of credit derivatives in accordance with either the Mark-to-Market Method set out in Article 269 or the Original Exposure Method set out in Article 270. Institutions may use the Original Exposure Method to determine the exposure value of items listed in Annex II and of credit derivatives only if they also use this method for determining the exposure value of these items for the purposes of meeting the own funds requirements set out in Article 87.

In determining the exposure value of items listed in Annex II and of credit derivatives, institutions shall take into account the effects of contracts for novation and other netting agreements, except contractual cross-product netting agreements, in accordance with Article 289.

Article 269 Mark-to-market Method

1. In order to determine the current replacement cost of all contracts with positive values, institutions shall attach the current market values to the contracts.
2. In order to determine the potential future credit exposure, institutions shall multiply the notional amounts or underlying values, as applicable, by the percentages in Table 1 and in accordance with the following principles:
(a) contracts which do not fall within one of the five categories indicated in Table 1 shall be treated as contracts concerning commodities other than precious metals;
(b) for contracts with multiple exchanges of principal, the percentages shall be multiplied by the number of remaining payments still to be made in accordance with the contract;
(c) for contracts that are structured to settle outstanding exposure following specified payment dates and where the terms are reset so that the market value of the contract is zero on those specified dates, the residual maturity shall be equal to the time until the next reset date. In the case of interest-rate contracts that meet those criteria and have a remaining maturity of over one year, the percentage shall be no lower than 0.5 %.

Table 1

Residual maturity	**Interest-rate contracts**	**Contracts concerning foreign-exchange rates and gold**	**Contracts concerning equities**	**Contracts concerning precious metals except gold**	**Contracts concerning commodities other than precious metals**
One year or less	0%	1%	6%	7%	10%
Over one year, not exceeding five years	0.5%	5%	8%	7%	12%
Over five years	1.5%	7.5%	10%	8%	15%

4.1.1 General provisions on calculating the exposure of an AIF (Box 93)

Generally the text should be much clearer about what is proposed to be calculated and what should be reported to the competent authority. It is in this section we believe important qualifications should be introduced to some of the terms which are taken up from the UCITS guidance in order to make the entire regime workable.

The statement in Box 93, "The exposure of the AIF should represent the extent to which the AIF may be impacted by the market risks attributable to its positions." is too vague to be at all meaningful. Furthermore it would be useful to clarify what is meant by the calculation being undertaken in a conservative manner. It is always possible to "understate" the exposure of the AIF because there is always some scenario even more adverse and more unlikely than those previously considered which would have a more adverse effect on the portfolio.

Netting Arrangements are never put in place with the "sole aim" of "eliminating" the risks. We understand this language is found in the existing CESR guidance but both phrases are unnecessarily restrictive when put into binding legislation, making it essentially impossible to comply with. Often portfolios that include derivatives are managed as a portfolio of risk exposures. The portfolio may have several hundred positions in it, sometimes more, and the manager focuses on managing the risks, rather than the positions, of that portfolio. If he wants to adjust the risk, he simply adds a new position to the portfolio. Within the portfolio there is lots of netting and hedging going on, but it is impossible to say that a particular position hedges another or that it is there to "eliminate" some specific risk. "Sole aim" and "eliminate" are conceptually too narrow as to have any operational meaning.

We have similar comments about Hedging Arrangements. It seems rare indeed that one would ever enter a hedge with the "sole aim" of "offsetting" a risk. If one has chosen to only partially offset, presumably there must be some other reason in mind otherwise the risk would have been fully eliminated.

Finally, the consultation often mentions "stressed market conditions" e.g. page 193 para 13, as if this is a defined term. Requiring a hedge to be "efficient" under stressed market conditions provides very little guidance as to how correlated a hedge has to be. To put it another way; one can always imagine a market stress so severe that any hedge will fail. So regulators will always be able to say that what was called an efficient hedge, in actual fact wasn't. The idea of reasonableness therefore needs to be incorporated into the text.

We note that the explanatory text does not use the concept of "sole aim".

4.1.2 Gross method of calculating the exposure of the AIF (Box 95)

We agree that long and short positions in "cash and cash equivalents" should be excluded from any calculation of leverage. (Box 95 paragraph 1(a) and (c)). It is important to exclude them to avoid double counting of exposures. We recommend that these definitions are more fully developed later, but question whether it is wise to include short-dated preference shares (as paragraph 2 of p199).

Box 95 paragraph 1(b) (and eg paragraph 13, p193) states that derivatives should be converted into the market value of the equivalent underlying assets of that derivative. We recommend that positions with limited downside (long option positions) should be represented by their maximum loss. This is especially important for long option positions. This is in line with the idea discussed in the consultation, which we fully support, that some positions or groups of positions have "limited loss boundaries" which limit their exposure.

Paragraph 1(d) is not entirely clear in how repo should be treated. A repo is nothing more than a collateralised loan or borrowing. The combination of a repo and a long position in the same security should result in the same exposure as a forward position in that security. Moreover the guidance given on p205 seems unhelpful. The idea that a fund "needs" to re-invest the cash proceeds to get a financing return greater than the financing cost is incorrect. The financing cost is part of the "cost of carry" – the cost incurred by holding a position. In a rational investment strategy, the *expected* return should exceed the financing cost, but there is no "necessity" about investing the cash proceeds into a yielding asset.

Paragraph 2 – we presume that the phrase "are fully covered by" means "are collateralised by".

4.1.3 Commitment method of calculating the exposure of an AIF (Box 96)

Definitions of and calculations on derivatives need to be clearer. It seems to me that if you have a portfolio consisting of an exposure (E) and a partially offsetting netting or hedging arrangement (N), then the leverage you would be report under the various approaches would be:

(a) Gross=E+N,

(b) Commitment-with-hedging=E,

(c) Commitment-with-netting=E-N.

If this is indeed the case, it should not only be clearer in the document but also an explanation should be given as to why this approach is thought sensible.

The requirement (Box 96 paragraph 2) that hedging arrangements can only be taken into account for the calculation of the Commitment Method where there is no return generated and where the "sole aim" is to "eliminate" a countervailing risk is, in our view, incorrect. Should be reviewed because it would potentially create a distorted picture as between AIFs. Conservative risk management will often involve "macro hedging" where portfolios are hedged across the piece rather than asset-by-asset hedging, the results of which will be substantially similar (and likely to be undertaken in the economic interests of the investors). As drafted only asset-by-asset hedging would appear to be allowed to be factored into the Commitment Method and only on the narrow basis referred to above.

We note that the examples of hedges given in the document by ESMA (page 202, paragraph 36) sensibly do not require a "sole aim" or "elimination".

Paragraph 2(a). Every position, including those which are deemed to be hedges aim to make a return under some scenario. The scenario doesn't even need to be adverse: many portfolio managers aim to construct portfolios which consist of a package of trades which, under a variety of different scenarios, is likely to produce a reasonable overall return. However under any one scenario some specific positions will do well and some will do badly, and the mix of positive and negative returns will be very different depending on the scenario. So who is to say what is hedging what?

Whilst AIMA regards the requirements to allow netting (as described on page 202) are generally overly strict, we welcome the ability to use netting arrangements which allow use of duration matching rules for interest rate strategies.

4.1.4 Advanced method of calculating the exposure of an AIF (Box 97)

We believe that the basic pillars and the underlying philosophy of the Advanced Method for calculating the exposure of an AIF are basically right. We come back, again, to the original definition of leverage as a method or an instrument which increases an exposure of the AIF. Where there is netting and offsetting of exposures, these should be duly taken into account as these will decreasing the exposure of the AIF.

4.1.5 Methods of increasing the exposure of an AIF (Box 98)

The proposed treatment of repos and similar instruments is not entirely clear. A forward position in a security (i.e. a security which is has been bought for a settlement date sometime in the future) is economically identical to the combination of a spot position and a repo position in that security. ESMA needs to make sure that in each case the exposure calculations yield the same result.

4.1.6 Exposures involving third party legal structures (Box 99)

Option 3 looks like the most sensible option because it conforms to a readily identifiable principle which can be understood and broadly applied.

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?

Given the wide spectrum of derivatives that can embed leverage, we do not believe it appropriate to prescribe a list of specific methods.

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

We welcome the opportunity to use an Advanced Method as an additional leverage measure. Although we understand that ESMA has considered whether it is appropriate to make the calculation of leverage under the AIFMD consistent with global exposure under the UCITS Directive and rejected it (e.g.

pargraphs 9ff on page 192), we believe that ESMA should reconsider whether the Advanced Method should either include VaR based methods to calculate leverage or whether such methods should be self standing methods to be chosen by the AIFM. The reasons for this are as follows:

- Consistency: not only is it sensible for investors who may wish to compare an AIF's risk profile with that of a very similar UCITS (i.e. like-with-like basis) but also this should make sense for regulators and the AIFM (to the extent that they may also be a UCITS manager). That said, we do not believe that, simply because an AIF may have similarities with a parallel UCITS that it should be required to use the CESR VaR protocol. Non-UCITS managers should be entitled to take up an Advanced Method that is either VaR based or otherwise as approved by their regulator]

- VaR: although it is established that VaR has shortcomings (as ESMA has indicated), its value is as a snapshot indicator of risk/exposure. Investors will typically understand that their investment can be lost but value a VaR number to show the magnitude of the risk that the AIF (or UCITS) is running.

- Proportionality: it seems to us to be both inconsistent and out of proportion that ESMA should be seeking to impose 3 (or 2) risk reporting measures in respect of AIFs (that are primarily intended to be available to institutional investors); this contrasts with the July 2010 CESR guidelines in respect of retail-focussed UCITS which only impose a single risk reporting measure.

ESMA is also asked to clarify which measures of exposure are to be calculated and provided to the regulator and/or investors. In Box 93, paragraphs 4 and 9 ESMA stipulates that the AIF may calculate exposure using the Advanced Method, as well as the Gross Method and the Commitment Method. However, in paragraph 11 of Box 93, AIFs only need disclose (to investors) the Gross Exposure and, if approved, the Advanced Method Exposure. Is ESMA drawing a distinction between the calculation obligation (i.e. must calculate all 3) and disclosure obligation (i.e. must only disclose 2) and, if so, why? Or is this an issue of the regularity of reporting to investors?

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

Yes. If a portfolio invests 100% of its assets into a long call option on a stock, is it massively leveraged or not? It might not be because it cannot lose more than it owns so can never default on its liabilities to its bank for example. However, it might be considered leveraged because for small movements in the price of the underlying stock, the value of the portfolio will change a lot.

No. To the extent that this is a question about whether e.g. options (and other derivatives) should be bounded by the maximum loss – the text (e.g. paragraph 4 on page 191) suggests that this is the case. We would suggest that para 1(b) in Box 95 incorporate this principle, namely that the market value of a financial derivative be bounded by the limit of the AIF's potential loss.

Q58:
Do you agree that when an AIFM calculates the exposure according to the gross method as described in Box 95, cash and cash-equivalent positions which provide a return at the risk-free rate and are held in the base currency of the AIF should be excluded?

Yes. This is welcomed and sensible but definition of "cash and cash equivalents" will need to be addressed.

Q59:
Which of the three options in Box 99 do you prefer? Please provide reasons for your view.
Option 3: it seems easily understandable and sensible to include leverage as exposure where there is legal recourse to AIF.

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?

As set out in Q59, leverage in a 3rd party entity should only be included in respect of a particular AIF if there is legal recourse such that the AIF's liability exceeds its investment value.

5 Possible implementing measures on limits to leverage or other restrictions on the management of AIF (section VII)

Q61:
Do you agree with ESMA's advice on the circumstances and criteria to guide competent authorities in undertaking an assessment of the extent to which they should impose limits to the leverage than an AIFM may employ or other restrictions on the management of AIF to ensure the stability and integrity of the financial system? If not, what additional circumstances and criteria should be considered and what should be the timing of such measures? Please provide reasons for your view.

The circumstances and criteria to guide competent authorities in undertaking an assessment of the extent to which they should impose limits to the leverage are too broad and go far beyond the powers prescribed in the Level 1 text. Article 25 clearly indicates that competent authorities should consider limiting leverage only 'to the extent to which the use of leverage contributes to the build up of systemic risk in teh financial system or risks of disorderly markets'. Intrusive powers such as limitation on leverage have the potential of imposing losses on funds and their investors and have therefore been heavily circumscribed by the legislator in the Level 1 text and should not be broadened in an implementing legislation. On the contrary, the delegated acts should further clarify the criteria for intervention in order to provide for proper substantial and procedural safeguards. This is fully in line with stated Commission policy to introduce, when empowering competent authorities to act in a preventative manner, adequate legal certainty, appropriate safeguards and restrict interference with property rights to what is strictly necessary and justified in the public interest.[3]

The draft ESMA advice states that competent authorities should be able to limit leverage even in circumstances where the AIF's exposures could constitute an important source of market, liquidity, or counterparty risk to a financial institution, meaning any financial institution without linking this power of intervention to the issue of systemic risk and general market disruption. Furthermore, ESMA contemplates that leverage restrictions could be imposed in circumstances where the use of leverage contributes or **may** contribute to the downward spiral in the prices of financial instruments or other assets, in a manner which threatens the viability of such financial instruments or assets. Apart from it being extremely difficult to understand what is meant by the concept of viability of an asset, limiting leverage of institutions simply because it could be the cause of a downward price spiral in a single instrument is exceedingly disproportionate and, again, fails to meet the crucial systemic risk test. For example, such arbitrary restrictions on leverage could prohibit funds from taking legitimate short positions on mispriced assets whose real economic value is zero or close to zero and would constitute an important breach of investor and property rights.

Accordingly, any action under Article 25 should be set at a level where the leverage in respect of a particular AIF managed by an AIFM could genuinely pose a systemic risk or a risk of a disorderly market, so that competent authorities cannot enforce leverage limits on AIFMs other than in exceptional circumstances. Furthermore, any situations in which competent authorities impose leverage limits on AIFMs for the AIFs they manage should be subject to prescribed and transparent escalation procedures.

3 http://ec.europa.eu/internal_market/consultations/docs/2011/crisis_management/consultation_paper_en.pdf

For example, the procedure could consist of several stages whereby at the first stage the AIFM is warned by their competent authority that if a specific level of leverage is breached then the AIFM will be subject to enhanced supervision. At the next level the AIFM would be required to explain and demonstrate their proposed approach to deal with the excessive leverage; at the next level they would receive a warning, and then only after all these measures are breached and the AIFM fails to resolve the leverage issue should the competent authority be able to impose a cap on leverage.

6 Transparency requirements (section VIII)

6.1 Introduction

AIMA members are happy to provide useful information to competent authorities and make sensible disclosure to investors. In regard to reporting to competent authorities, we would however, urge ESMA to cooperate closely with other organisations such as IOSCO and the SEC to achieve greater global consistency in this field, both in terms of frequency/timing and of content of reporting. Inconsistent requirements will not only impose unnecessary costs on AIFM but will also prevent comparability of data collected by different regulators. We believe that the frequency of reporting that is currently proposed is not proportionate for all AIFMs and that a tiered reporting obligation should be considered.

There is a link between the provisions on transparency and the requirements that apply to third country AIFM. AIMA believes that the applicability of the transparency provisions should not be used as a pretext to introduce substantial requirements on third country AIFM, which was clearly not intended in the Level 1 text. AIMA will make further comments in relation to this issue in our response to ESMA's consultation on Third Countries.

6.2 Possible implementing measures on annual reporting (section VIII.I)

6.2.1 Summary

AIMA is concerned that there is still some lack of clarity as regards whether the requirement to produce an annual report is on the AIF or the AIFM. We would also ask that ESMA to a further extent considers professional investors' ability to interpret data and perform due diligence on the AIF. We believe there is a risk that, as currently drafted, the provisions on remuneration may function prejudicially against smaller managers as it will be fairly easy to identify individuals.

6.2.2 Annual report definitions (Box 101)

We recommend the deletion of the last phrase within the proposed definition of "material change" meaning that the definition will be as follows:

'Material change' *(for the purposes of Article 22(2) (d) and with reference to Article 23, where appropriate) means changes in information if there is a substantial likelihood that a reasonable investor, becoming aware of such information, would reconsider its investment in the AIF.*

The function of the definition is to act as a hook for disclosure on a periodic or ad hoc basis of new facts that may be relevant to an investor. An appropriate test for relevance is whether the fact would, were it known to the investor, influence his or her investment decision. This test is familiar as it stands, for example, the definition of 'material' within IAS1 in the context of omission is as follows:

"Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor."

Listing specific factors diminishes and restricts the general application of the concept of materiality, which is well understood within the context of financial reporting.

6.2.3 General principles for the annual report (Box 102)

In our initial response to the CESR call for evidence, we commented that the AIFMD is unclear as to whether the requirement to produce (as distinct from "to make available") an annual report applies to the AIFM or the AIF. The ESMA Consultation continues the ambiguity and we would recommend that it be resolved expressly by recognising that while, under Level 1, Art 22, the AIFM is obliged to make available an annual report to investors in relation to the AIF it manages, the preparation of several components of that report properly belong to the governing body of the AIF itself. Accordingly, we would submit that

the AIFM may discharge itself of its obligations to make disclosures under Article 22, to the extent that disclosure obligations are met by the governing body of the AIF. We would recommend as well that, as under the UCITS Directive, where the governing body of the AIF prepares the annual statements, the document containing them can be supplemented by the inclusion of an annual Investment Managers Report (a mechanic which is contemplated but not explored in paragraph 25 on page 225 of the proposed advice).

On that basis, we recommend the annual report of the AIF include the following reports:

- Audited financial statements (comprising balance sheet and statement of income and expenditure) presented in accordance with US GAAP or IFRS or equivalents.
- Directors' Statement and Report. The Statement will conclude that the financial statements have been presented fairly. The Report will present the performance of the AIF for the period and any other significant events as required to be disclosed under Article 22, particularly with regards to paragraph e) and f), and Article 23.
- Any local statutory requirements.

As a separate document, but comprised within the annual report, and not subject to audit, there can also be included, the Investment Managers Report, to make the disclosures necessary under Article 22, to the extent not already made in the Directors' Report, and Article 23.

It is our opinion that the disclosure in the annual report does not need to include significant further information. This is because the type of investors in an AIF are in a position to make their own thorough due diligence in a way that best suits their own needs and on a more timely basis that by relying on information included in the annual report. If there is further disclosure in the annual report, for example, in line with UCITS fund disclosure requirements, it may suggest there is no need for this due diligence or suggest a level of regulatory comfort that does not exist.

Paragraph 3: The first sentence is a good addition to the Level 2 rules to ensure that advantages provided by local jurisdiction for AIFs can be taken. Further clarity could be provided by extending the first sentence to identify that accounting rules can be followed where it is permitted by law *in the Member State of the AIF*. We would suggest the remainder of the paragraph be deleted as it is redundant, particularly if the role of the AIF's governing body is properly recognised. Furthermore, it will often not be possible for the AIFM to decide what is 'appropriate', particularly in circumstances where the financial reporting documents are the responsibility of and are being prepared on behalf of the AIF.

Paragraph 4: The first sentence reading 'All information provided in the annual report,….shall be presented in a manner that provides materially relevant, reliable, comparable and clear information' is duplicative, and the phrase quoted should be deleted, as the accounting standards already state that this is required. The second sentence states that 'the AIFM shall ensure as far as reasonably possible that the annual report contains the information investors may need in relation to particular AIF structures.' As noted in our general comment, the AIFM will, in many circumstances, be restricted to a greater or lesser extent with regard to its ability to dictate the format of the annual report.

6.2.4 Reporting material changes for the annual report (Box 103)

With regard to paragraphs 1 and 2, we refer you to our comments above. The Level 2 advice needs to reflect the possible role of the governing body of the AIF in the preparation of annual accounts, reflecting its fiduciary obligations to investors. References in these paragraphs should be to the AIF or the AIFM as appropriate.

With regard to paragraph 3, we submit that this paragraph is redundant. To the extent that the financial statements relating to the AIF have been compiled in accordance with the requirements of IFRS, or local accounting standards, it is inappropriate for the AIF's governing body (or AIFM) to seek to second guess those standards, which have international approval, and add or interpret information further. It will not be possible or practical for them to guess what particular investors might wish to be told, or need in order "to understand the impact of the change". Furthermore, ESMA should not forget that, in the AIF arena, investors will be professional investors, not private individuals,who may be assumed to be fully competent and who will conduct their own due diligence. It is reasonable to assume that they will

understand accounts prepared using internationally recognised accounting standards and also to recognise that they will ask questions (as they currently do) if there are matters they do not understand.

With regard to paragraph 4, the phrase "together with any potential or anticipated impact on the AIF and/or investors of the AIF" should be deleted. It is unreasonable to expect either the AIF or AIFM to be able to make forward looking guesses as to potential impact, particularly as they will not be aware of the particular circumstances of any investor and will be quite unable to say what the impact of a particular event will be for a particular investor. Their circumstances and hence impacts will all be different and specific to themselves.

6.2.5 Primary financial statements required under Article 22 (2) and (b) of Directive 2011/61/EU (Box 104)

We refer you to our comments with regard to section 6.2.3 (Box 102) above. It should be specified that, throughout this Box, references to AIFM should be amended to incorporate references to the AIF if that entity is preparing the balance sheet and income and expenditure account. In those circumstances, the AIFM has no role, other than as a provider of information and references to circumstances requiring the AIFM to substitute or amend line items prepared by the AIF in the balance sheet or income and expenditure statement to ensure compliance should be deleted, as inconsistent with the fundamental apportionment of responsibilities between the two entities (see e.g. paragraphs 2 and 8).

While we generally have no particular concerns with the approach adopted, we are concerned that there is a requirement for too great specificity in some cases.

- In paragraph 1 (a) (ii), we have already commented on the difficulty of identifying cash equivalents. This reference should be deleted.
- Paragraph 2: if the financial statements have been prepared by the governing body of the AIF and audited, it is inappropriate for the AIFM to recast financial information. This paragraph should be amended accordingly.
- Paragraph 7 (a) (ii) and (iii): the distinction between realised and unrealised gains seems unnecessarily prescriptive and should be deleted.
- Paragraph 10: we were unclear what is intended by this paragraph that is not already covered elsewhere. This should be deleted.
- Paragraph 11: there should be a reference to materiality in this paragraph, as elsewhere.

6.2.6 Content and format of the report on activities for the financial year (Box 105)

We stress that this report should be the responsibility of the governing body of the AIF, and not the AIFM, unless there is no governing body of the AIF. The AIFM's report should be included as a separate element of the Annual Report. Accordingly, the report of the Directors should deal with the matters referred to in paragraph 1(a) and 1 (b). The matters referred to in paragraph 1 (c) should be dealt with in the Investment Managers' Report.

We do not see the need for the risk description referred to in paragraph 2, which should be deleted. There will be an ample description of risk factors and risk mitigation policies described in the general disclosures made under Article 23, together with a description of relevant material changes, so this paragraph appears redundant and should be deleted.

Similarly, paragraph 3 is also inappropriate. The investment strategy and activities will have been described under the disclosure obligations set out in Article 23 1(a). The Directors should not in their report be required to further educate professional investors in the investment strategy of the AIF or to include either financial or non-financial key performance indicators over and above the balance sheet and statement of income and expenditure. Investors should make their own analysis of performance, judging by criteria which are relevant to them. It should not be a requirement on the Directors for them to judge their own performance, particularly as they will be very unlikely to know all the relevant criteria by which particular investors may assess their performance. Investors will have had regular

communications from the AIFM and/or AIF and there will be at least an annual statement of AUM or other measure of NAV made in accordance with Article 19.

6.2.7 Content and format of remuneration disclosure (Box 106)

Firstly, we are concerned that these provisions will function prejudicially against smaller managers. The overarching nature of the disclosure obligations will almost inevitably result, in the case of smaller managers, in the disclosure of sufficient information so as to enable readers to work out more or less precisely the individual payments being made to the principals managing the AIF. This information will, by contrast, not be obvious or easily deduced in the case of larger managers, managing several AIF, where remuneration may well not be based or referable to the performance of a particular AIF.

As to paragraph 1, we agree with ESMA's approach that there should not be an obligation to disclose a split by beneficiaries, as such approach would result in disproportionate disclosures, infringing fundamental rights of the beneficiaries.

We note, in paragraph 4 of the Box and paragraph 30 of the Explanatory Text the proposal with regard to proportionality. We would suggest more clarity and we support the views expressed elsewhere that the remuneration disclosures should be subject to similar exemptions as are available to firms under the Capital Requirements Directive (2006/48/EC), which effectively allows information that is immaterial, confidential or proprietary not to be disclosed. The implementation of similar exemptions would ensure a level playing field across all firms subject to remuneration disclosures, which was one of the original objectives of the G20 when remuneration proposals were first tabled. In particular, we would recommend that the disclosures not exceed the disclosure obligations under Appendix 2 ("Pillar 3 Disclosure Requirements by Proportionality Tier") to Appendix 2 ("Applying the Remuneration Code Proportionately") of the FSA Remuneration Code. ESMA should consider that excessive data collection and disclosure obligations will significantly increase the AIFM's costs at times where trading margins are increasingly thin. Excessive disclosure requirements would not be proportionate.

We support the ability for the AIFM to determine whether to provide the disclosures at the level of the AIF or the AIFM. This should provide sufficient flexibility for AIFMs to be able to implement a solution that reflects the nature, scale and complexity of the AIFM and consequently results in a proportionate application of the obligations.

In the case of umbrella funds it is not clear whether the remuneration disclosures should be at sub-fund or umbrella level.

From a practical perspective, we still note (as we did in our response to the CESR call for evidence) the following difficulties implied by the text:

- that the AIF has control (which is does not) over the remuneration of the AIFM and how it is split between staff at the AIFM;
- that the remuneration is linked to the performance of the AIF where, in most cases, the remuneration would be linked to the performance of a number of AIF managed by the AIFM; and
- that the remuneration is for the period of the AIF's annual report period, whereas in most cases, the remuneration will reflect a different period. This could result in some AIF showing remuneration of zero because remuneration allocations have yet to be made at the AIFM.

The text in Box 106 provides various solutions to these difficulties, but we would repeat the point that remuneration disclosures which do not take account of these factors have the potential to be misleading.

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?

Please see our comments with regard to section 6.2.2 (Box 101) to section 6.2.6 (Box 105), set out above.

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?

Please see our comments with regard to Box 106 set out above.

6.3 Possible implementing measures on disclosure to investors (section VIII.II)

6.3.1 Summary

- **Frequency of reporting:** disclosure should be triggered when something material changes relative to previously made disclosure. AIF should not be tied into a reporting cycle if nothing has changed. If necessary, confirmation of "no change" could be included in the annual report.
- **Rules should not be too prescriptive:** appropriate disclosures will vary widely among different types of AIFM - depending on strategies, asset classes and AIF types - so the rules should be broad enough to permit this.
- **Prescribing a format is not necessary:** the wide differences between different types of AIF will make a prescriptive format unworkable. However, it should be possible under the rules to make disclosures via electronic mail, website or other paperless means provided that the method of disclosure has been clearly communicated to all investors (e.g., in the prospectus).
- **The relevance of UCITS provisions:** This is an area where we would strongly caution against the adoption of rules based on the UCITS implementing regulation.

6.3.2 Periodic disclosure to investors (Box 107)

Assets subject to special arrangements:

Percentages disclosed may be of gross (e.g., including leverage) assets (assuming there will be a leverage disclosure) or net assets, provided that the disclosure is clear as to which. We would make the point that simply performing a percentage of net asset value calculation is unlikely, of itself, to produce relevant information, as assets held subject to special arrangements will be valued downwards in most circumstances, and so, as a proportion of current net asset value, will usually appear small.

The disclosure requirement should be triggered when special arrangements are applied. For example, if the AIF governing body decides to apply a gate, that should trigger disclosure of the percentage of assets subject to that arrangement. Likewise, if assets are transferred to a side-pocket arrangement, the percentage of assets that have been side-pocketed should be disclosed.

It may be that on first implementing the special arrangements, an AIF is not able to give an accurate indication of the percentage of assets which will be subject to such arrangements. Accordingly, such disclosure may be delayed until the AIF is able to do so (typically following the next valuation point for the AIF).

We approve paragraph 3, which we think leaves the appropriate level of flexibility to take account of different AIF assets classes.

New arrangements for managing liquidity: We support the approach adopted by paragraphs 4 and 5. Liquidity management arrangements will have been described in the AIF's prospectus, so this disclosure only needs to be made if/when there are material changes to such arrangements. If no new arrangements have been adopted, annual confirmation thereof would be sufficient (such disclosure could be made in the annual report) but this should only be required for AIF that are being actively marketed.

23(4)(c): Risk profile and risk management

ESMA should avoid adopting UCITS requirements, which are ill suited to the diversity of AIF risk management techniques. References to "disclosing the current risk profile" on a periodic basis will be substantially redundant. The disclosure required will vary widely among different types of AIF depending on their strategy, asset class, etc. and the rules must be able to accommodate a broad range of approaches.

We assume that the risk profile will have been disclosed in the AIF's fund offering documents or in the initial disclosures made under Article 23. There should not be any reason for a well prepared risk management system to be altered frequently, if it properly addresses contingencies. Accordingly, periodicity of reporting should not be frequent either. As with the above, we would suggest that if there has been no change in these matters, confirmation thereof on an annual basis should suffice (for funds which are still being actively marketed).

With regard to the 2 options given for disclosure of Risk Profiles, we do not support either as currently proposed.

Option 1 is impractical and requires an element of guess work and hypothesis on the part of the AIFM which is impossible. The AIFM cannot with any certainty state risks to which an AIF "could be exposed". Furthermore, we do not consider it serves any useful purpose to state circumstances where " risk limits set by the AIFM have been, or are likely to be, exceeded". It creates potential liability, but without any method of measurement or control.

We do not consider it serves any useful purpose for investors to have circumstances where risk limits are or may be exceeded disclosed to them. Risk limits are management tools, which will be set to measure a variety of indicators. Exceeding a risk limit might occur simply as a matter of market movement or some other factor outside an AIFM'scontrol. Once exceeded, however, on the basis that the risk management organisation of the AIFM complies with its obligations under Article 15, we would expect appropriate remedial action to be taken. This would be entirely usual. Forcing a disclosure under these circumstances may well result in a misleading view for investors.

It is because of this view, that we propose that Option 2 may be a better option, but subject to the deletion of paragraph 3(c). AIFM may take the view that disclosing the results of a recent stress test is helpful in disclosure relating to the risk profile of the AIF. Such disclosure should be optional. We would also argue that this requirement goes further than is permitted by the Level 1 text.

With regard to paragraph 6, we propose that the references to "anticipated impact" on investors be deleted. The AIFM is not in any position to make this judgement. Each investor's circumstances will be unique.

6.3.3 Regular disclosure to investors (Box 108)

We have no specific comment on the requirements proposed as set out in Box 108. However, we do think that this paragraph adds further emphasis to the crucial importance of ESMA creating the right regulations with regard to the calculation and disclosure of valuation methodologies and the mechanics AIFM will use to calculate leverage. Adoption of the wrong methodology will result in routine publication of figures which are entirely misleading and which do not correspond to any measures or benchmarking methodologies actually and routinely used in the markets or by investors in AIF to measure exposure.

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?

Please see above. Liquidity management provisions do not give rise to issues. Risk profile disclosures as proposed would, and in circumstances where there does not appear to be any corresponding benefit.

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

We support a modified version of Option 2, for the reasons set out above.

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.

No. We think further specificity would serve no purpose and would be likely only to confuse.

6.4 Possible implementing measures on reporting to competent authorities (section VIII.III)

6.4.1 Summary

AIMA's key concerns in relation to reporting to competent authorities are essentially the frequency and the contents of reporting, which we have described below. Also, we would urge ESMA to seek further global harmonisation on these issues to reduce the administrative burden on firms that are active in multiple jurisdictions and to increase the comparability of data collected between regulators.

6.4.2 Format and content of reporting to competent authorities (Box 109)

ESMA should take into account the need to minimise the administrative burden on, among others, competent authorities arising out of the transparency requirements of the Directive. Consistent with this, it is our view that the information required by paragraphs 1, 3 and 6 should be provided by AIFM on an annual basis, other than in the case of the very limited number of AIF whose activities and size are such that they might be deemed to have the potential to be systemically significant, in which case quarterly reporting may be reasonable. For this purpose, we propose that a benchmark for possible materiality be set at EUR 3 bn. Where closed-ended funds have low levels of turnover and market conditions are stable it is envisaged that it may be appropriate for them to report on a semi-annual basis where they have assets under management in excess of €3bn or on an annual basis where they have assets under management below this threshold.

With regard to the timeframes for reporting, we would submit that the appropriate general requirement should be for a two month preparation period.

To address these concerns, we propose that paragraphs 4 and 5 should read as follows:

- Where an AIFM is required to report under paragraph 3 it shall provide the information required under paragraph 3 and paragraph 1 on an annual basis, except where the AIF's assets under management exceed a threshold of EUR3 billion, in which case the AIFM shall provide the information for the AIF on a quarterly basis. The information shall be provided no later than two months after the end of the relevant period.
- With exception to paragraph 4 and where the competent authority deems it appropriate it may:
  a) allow an AIFM to report all or part of the information on a less frequent basis having considered the stability and consistency of assets held and taking in to account the frequency of portfolio turnover and existing or anticipated market conditions. In these circumstances the reporting period shall be at least semi annual for an AIF with assets under management exceeding a threshold of EUR1 billion, and at least annual for all other AIFs; or
  b) require an AIFM to report all or part of the information on a more frequent basis.

The proposed framework under which AIFM shall report to competent authorities is delineated in terms of the nature, scale and complexity of AIF. It sets default reporting frequencies for AIF as set out in the table below:

Default reporting requirements;

Reporting requirement	Frequency Options	
	AIFM, with AUM </= €3bn	AIFM, with AUM > €3bn
1) Report a set of core information (Article 3 (3) (d) and 24 (1) for each AIF	Annual	Quarterly
2) Report information required under Article 24 (2) (a) to (d) for each AIF	Annual	Quarterly
3) Additional information required by AIFM managing one or more AIF employing leverage on a substantial basis (Article 24 (4))	Frequency should be in line with that set out in 2) above	

In addition, whenever there has been a change to the existing status of the information the AIFM has provided to the competent authorities (for example, a change in the way in which the liquidity of the AIF is managed) this should ensure that competent authorities receive (and are able to identify) only the information which is likely to be useful to them in monitoring risk.

We also think that to avoid competent authorities being swamped with information (as would occur if all AIFM had to provide information by reference to a calendar year), the timescale should be determined by reference to the financial year of the AIF.

It should be possible for the AIFM to provide any item of information required to be reported to competent authorities electronically (although submission of paper information should also be acceptable).

We recognise that some Member States may wish to impose more frequent reporting schedules, but consider that they should do so under national law, rather than through the framework of ESMA's regulation.

6.4.3 Use of leverage on a 'Substantial Basis' (Box 110)

Please see our comments on section 6.3.3. (Box 108) above, which apply.

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

No, for the reasons set out above.

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.

Costs are likely to vary across the different AIFs. We caution against assuming an ease of reporting when looking at more traditional funds whose main investments include liquid listed securities. A number of hedge funds are active in the OTC derivatives space where an easy description and/or pricing of instruments may not be subject to an easy and cheap reporting arrangements.

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?

No. The data required represents a very substantial collection exercise for those to whom it is relevant and will impose a significant operational burden on firms. Systemic information will be available from other sources on a regular basis and regulators retain an ad hoc power to require information at shorter notice and on different bases should they need it. A two month period is more reasonable.

ANNEX – Impact Assessment: Depositary Provisions

I. Scope and approach of the study

- ESMA (the European Securities and Markets Association) released their draft Level 2 guidance on the Alternative Investment Fund Management Directive on 13th July 2011. Interested parties have had two months to respond to the consultation document. The hedge fund industry faces a critical period to present its recommendations back to ESMA who will publish its final advice in November.
- Before the Commission publishes its final text, AIMA – the hedge fund industry representative trade body – will provide its collated feedback and recommendations in order to influence the outcome for the industry in the technical Level 2 measures.
- AIMA has commissioned an independent advisory firm to undertake a focused market study of the proposed implementing measures outlined in ESMA's Consultation Paper relating to Depositories (Section V) in order to support its recommendations and response back to ESMA.
- Under Article 21 of the Directive, a Depositary is defined to be:

  (a) a credit institution having its registered office in the Union and authorised in accordance with Directive 2006/48/EC;

  (b) an investment firm having its registered office in the Union, subject to capital adequacy requirements in accordance with Article 20(1) of Directive 2006/49/EC including capital requirements for operational risks and authorised in accordance with Directive 2004/39/EC and which also provides the ancillary service of safe-keeping and administration of financial instruments for the account of clients in accordance with point (1) of Section B of Annex I to Directive 2004/39/EC; such investment firms shall in any case have own funds not less than the amount of initial capital referred to in Article 9 of Directive 2006/49/EC; or

  (c) another category of institution that is subject to prudential regulation and ongoing supervision and which, on 21 July 2011, falls within the categories of institution determined by Member States to be eligible to be a depositary under Article 23(3) of Directive 2009/65/EC.

- Given the time limitations of this project, this study involved interviews with 9 key global custodians and prime brokers and with 5 hedge fund managers. In addition, the study leveraged AIMA's membership base of 700 members for validation of the study's assumptions via an online questionnaire (14 responses received).
- The study's objectives were to:
  - Seek the view of industry participants potentially impacted by the Depositary related provisions in the Directive;
  - Inform AIMA's analysis and submission of its response back to ESMA;
  - Obtain reliable, evidence based and relevant information.
- This study and this report are additional to and independent from the consultation response that AIMA are preparing to submit back to ESMA on 13 September 2011.

- Profile of respondents:
    - Depositary respondents were selected on the basis of:
        i. Entities owning large numbers of affiliated sub-custodians compared to those who had predominantly unaffiliated sub-custody networks;
        ii. Entities whose parent corporate bank was active in wholesale banking (eg payments, trade finance etc) and those that were not;
        iii. Mixture of European and US headquartered institutions
    - Respondents included representatives from the Association of Global Custodians (AGC) and the Association for Financial Markets in Europe (AFME).
    - The study involved face to face interviews with 5 hedge fund managers selected based on criteria including size (assets under management), investment strategy, and whether or not their primary fund range was on-shore or off-shore. In addition, feedback was received from 14 additional managers via the on-line electronic questionnaire submitted through AIMA's website.
    - The interviews and follow-up sessions were conducted between 8 August2011-7 September 2011.

II. Background

a. The broader AIFM Directive impact

- The Directive has ramifications far beyond achieving tick-box compliance. Alternative investment groups including promoters, sponsors, advisers, general partners and managers of all types of non-UCITS funds are conducting strategic reviews of their fund ranges and their operating models.
- According to the FSA's Impact Study 2009 (Charles River Associates), benefits accrue to investors from the EU-wide 'passport' which brings access to funds not previously marketed in certain member states. This would enable efficiencies to be exploited, thus lowering marketing costs. An EU AIFM managing an EU AIF will have to comply with all provisions of the Directive from 2013 when they will have the passport available to them, although it is expected that the majority of EU AIFM clients managing non-EU AIFs will remain under the private placement regime for as long as possible
- However, investors will also need to consider the potential increased barriers to entry for new and smaller managers and therefore limitations of choice to products and the impacts this may have on their portfolio diversification models. The Directive will also have consequences for their investment process due to expected increased costs. These will be both fixed (one-off) and variable (on-going) cost impacts.
- Ongoing compliance and risk management costs may also be passed on to investors, leading to reduced returns. Significant running costs, arising from the need for depositaries to price in new liability related premium and capital charges as well as operational changes such as monitoring/oversight functions, are expected to be passed on to Alternative Investment Funds (AIFs). Restrictions in usage of certain valuers, prime brokers and global custodians may result in reduction of choice and a corresponding increase of fees. AIFs may be forced to pass these costs on to their investors.
- Specifically, many depositaries have not previously had to operate by, and price in, liability to the extent proposed in the Consultation Paper and have indicated that this contingent risk would force them to hold costly additional capital to mitigate potential losses. Some depositaries may reduce the size of their sub-custodian networks in foreign locations such as emerging and frontier markets which could also have a negative impact on investor choice. Insufficiently capitalized depositaries may have to exit the market altogether.
- For cash settled markets, some depositaries may be forced to move into synthetic trading as a result of the sub-custody network liability requirements under AIFMD in order to avoid the risks associated with holding client cash assets. Where the instruments are traded OTC (Over-The-Counter) and face regulation under EMIR (European Market Infrastructure Regulation), again this is expected to lead to increased costs of doing business.
- Should managers choose to re-domicile their funds, the total costs of restructuring, establishing new legal and tax structures and relocation could be considerable.
- Other key concerns for European hedge fund managers relate to potential restrictions in the use of leverage and disclosure requirements regarding remuneration.

b. The Uncertainty over Depositary related implementing measures

Based on interview and survey findings, Depositary respondents foresee the liability provisions as the greatest potential impact on the service charging structure for their hedge fund clients. There also remain a significant number of uncertainties in the implementation measures of the Directive that mean they are as yet unable to fully quantify the cost-benefit. These uncertainties are in relation to two key outcomes arising from the proposed implementing measures:

- **Liability related issues** as a result of delegation activities (for example, where the global custodian as Depositary delegates to local agent banks or where the prime broker delegates to local agent banks if acting as unaffiliated sub-custodian to Depositary) including the extent of the reverse burden of proof, the uncertainties regarding definition of external vs. internal events and the definition of loss, impacting services such as custody, trustee, depositary and settlements.
- **Operational complexity** arising from additional/new functional requirements such as the need for the Depositary to act as a central hub for cash monitoring services, potential mirroring of all transactions and new tri-party arrangements between global custodians and prime brokers requiring 're-papering' of contracts.

The reverse burden of proof which could require the Depositary to seek liability mitigating measures, for example, for fraud 'downstream' of the custody chain such as at the local agent bank or an unaffiliated sub-custodian, may result in the concentration of custody in a smaller number of bigger banks capable of withstanding this liability, thereby concentrating risk for the industry.

In turn, these banks that are able and willing to take on this liability will be more closely interlinked through their custodian networks, further increasing the interconnectness of the financial system. It is also worth noting that the appointment of a depositary by the AIFM / AIF will mean that the AIF / Primer Broker/ Depositary relationship will need to be completely re-negotiated in terms of tri-party contractual agreements. Respondents also believe that Depositaries seeking any form of insurance for the liability risk that they potentially take on will also be uninsurable due to the size of expected risk they may have to bear.

There is a trade-off between the additional risk premium that these changes will mean for Depositaries' service charges, and the fee charges that hedge funds (AIFs) will be prepared to pay for these services without detrimentally impacting their total expense ratio (TER) and ultimately, their performance returns.

III. Our key findings

- Based on Depositary respondents' estimates, under the strict liability regime as it is proposed by ESMA's Consultation Paper, the industry could face increased costs at least 4-to-5 times than that of today.

- Potential anticipated total costs to the European industry under the implementing measures proposed could be at least $6bn or more under severe liability provisions. This uplift takes into consideration both fixed and variable cost charges but the largest proportion is expected to result from the liability related provisions.

- As AIFMD will apply to all non-UCITS (eg. hedge funds, real estate funds, infrastructure funds, private equity funds etc), Depositary respondents cannot specifically apportion the potential cost increases per specific client segment with regards to restituting assets which have been 'lost' and the liability regime. They have assumed base servicing charges across their business such as settlement, custody or trustee services, will increase as indicated.

- Depositary respondents expect that they will have to pass on a considerable percentage of the burden of their increased liability and resulting costs to their clients.

- Depositary respondents highlight that mid-sized depositaries that are not sufficiently capitalised could make a decision to exit certain markets/services, concentrating the number of remaining service providers to a smaller number. This in turn would reduce choice for funds' wishing to trade in these markets as part of their investment strategy.

- Some Depositary respondents have indicated that an additional unintended consequence regarding uncertainty over the liability responsibility within the custody chain is that it could lead to an increased appetite for synthetic trading such as over-the-counter derivatives, seemingly counter to the Directive's original objective of achieving greater transparency in the financial markets.

- The majority of manager respondents indicate that increased costs of doing business as a result of increased servicing charges would have to be passed on to the Fund, thereby impacting its Total Expense Ratio (TER). This is in turn would, unavoidably, be borne by investors in the fund.

- The result of increased fund TER and limitation of tradable asset classes/markets could lead to more expensive, less diversified product ranges for prospective fund investors in Europe.

a. Depositary findings

The study has defined a framework for consideration of the cost impact in terms of ESMA's various implementation options as set out in the Consultation Paper.

- Scenario 1 is a future state where the additional requirements and liability burden are mitigated, with the liability loss being restricted to only include affiliated agents where the Depositary has control.

- Scenario 2 is a future state where the additional requirements and liability burden are unmitigated with the Depositary potentially having to assume liability for the entire sub-custody chain, regardless of whether these include unaffiliated 3rd party agents over which the Depositary has no control.

Cost impact Scenario definitions

	Scenario 1 Parameters	*Scenario 2 Parameters*
Description of liability related issues and operational complexity impacting prospective Depositaries under ESMA's proposed implementing measures	**Box 76 - Proper monitoring of cash-flows (Option 2)** **Box 78 - Definition of the financial instruments that should be held in custody (Option 2)** **Box 79 - Treatment of collateral (Option 3)** **Box 81 - Safekeeping duties related to 'other assets' – Ownership verification and record keeping (Option 1)** **Box 86 - Clarifications of the depositary's oversight duties (Option 1)** **Box 90/91–Definition of loss , External event definition, with clarity over legal definitions of 'internal' vs 'external' with assumption that Depositary is not liable for example where it deems not to have control, clarity over definition of loss of assets and restitution of non-fungible assets.**	**Box 76 - Proper monitoring of cash-flows (Option 1)** **Box 78 - Definition of the financial instruments that should be held in custody (Option 1)** **Box 79 - Treatment of collateral (Option 1)** **Box 81 - Safekeeping duties related to 'other assets' – Ownership verification and record keeping (Option 2)** **Box 86 - Clarifications of the depositary's oversight duties (Option 2)** **Box 90/91–Definition of loss , External event definition, with uncertainty/lack of clarity over legal definitions of 'internal' vs 'external' with assumption that Depositary is liable despite it deeming the relationship to be out of its control, lack of clarity over definition of loss of assets and restitution of non-fungible assets.**

i. Cost impact summary

- The table below identifies the current minimum and maximum servicing charges in basis points for respondents of the survey.
- Respondents have estimated the service charge increases incorporating both fixed/one-off costs, such as new technology investment, and variable/on-going costs such as additional personnel.
- The pricing of liability related risk premia and capital charges have been estimated as an 'all-in' cost into the additional responsibilities proposed by the options laid out in the Consultation Paper; respondents are not able to assign this uplift to specific services.
- Respondents have estimated the 'all-in' uplifts (i.e., 10-25bps and 100-150bps) during the interviews based on their current understanding of the ESMA proposals; the majority of these increases are apportioned to liability related issues.
- These uplifts may be across their non-UCITS business, not just hedge funds, but respondents are unable to apportion without further detailed analysis at this stage.

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		Current State		Future State –Potential % increases	
		Average Service Charges In bps		SCENARIO 1	SCENARIO 2
		Min	Max		
Core services potentially impacted	Reconciliations, T/A, Fund Accounting	10	15	0%-10%	Unknown/No responses
	Custody Services	2	5	10%-20%	50%-100%
	Trustee/Depo Bank	1.5	10	10%-20%	50%-100%
	Other (for example: Settlement)	6	6	0%-10%	0%-10%
	Total average service charges	**Circa 20**	**Circa 35**	**Different depositaries will choose to allocate the uplift costs in different ways across their services depending on their business models.**	
New/additional responsibilities incurred through AIFMD	Cash Flow Monitoring	n/a	n/a	Not attributable to specific service but expected increases of 30%-100%	
	Safe-keeping	n/a	n/a	Not attributable to specific service but expected increases of 30%-100%	
	Loss Definition/Capital Liability	n/a	n/a	Not attributable to specific service but expected increases of >100%	
	'All-in' impact	n/a	n/a	**Estimated 10-25bps**	**Estimated >100-150bps**
Other services potentially impacted	Financing	Not quantified by respondents/bundled service			
	Execution	5	20	0%-10%	>100% (only if ex-ante applies)
	Cash Management	Charged differently per bank (eg transaction-based)/ Cash Monitoring is implicit in this service			
	Collateral Management	Charged differently per bank/Not quantified by respondents/bundled service			

Table 1: Current average service charges and estimated impact based on respondents' feedback (Depositary)

ii. Respondents' feedback to ESMA's specific questions on cost impact:

ESMA's Consultation Paper sets out a proposed list of options under each of the key Boxes. Depositary respondents feedback was collated with regards to each of the options proposed per Box.

ESMA CP reference	*Option 1*	*Option 2*	*Option 3*
Box 76: Proper monitoring of cash flows	• "At a minimum, a doubling of costs." • "Estimated additional 55 people just to do compliance checking plus an additional 1-2bps for liability implications." • "Increased costs for cash management services." • "An extra 40% for reconciliations and checks required." • "Cash management will need to command a new fee unless there is a compromise." • "30-100% increase in costs expected – this is only the running costs, so you also need to factor in the additional costs for systems build/investment etc." • "Option 1 is unthinkable and operationally impossible." • "You are effectively stopping STP."	• Respondents have indicated that Option 2 is preferred.	• N/A
Box 78 - Definition of the financial instruments that should be held in custody	• "How can I define 'financial instruments'? What about private equity, real estate or fund of fund assets – how can I get comfort over the existence of the assets if all I have is a statement from the registrar or held under Nominee name? Nominees are not necessarily custodians."	• Respondents have indicated that Option 2 is preferred.	• N/A
Box 79 - Treatment of collateral	• "This is a complete no-no." • "What is defined as collateral vs not? What fund assets will be accessible vs not? What is the proposed model between custodian and prime broker? This is not clear."	• "We are not clear how this will work for non-EU deals." • "Our clients may be able to fit into this definition."	• Respondents have indicated that Option 3 is

	• "The interface between the custody of the assets and the give-up to the PBs is the heart of the matter, plus segregation of the assets and making assets available to investors (because of co-mingling)." • "Regulators will want assets to be ring-fenced; account segregation by securities transfer vs. custody accounts (co-mingled)."		preferred.
Box 81: Safekeeping duties related to 'other assets' – Ownership verification and record keeping	• Respondents have indicated that Option 1 is preferred.	• "Option 2 is unthinkable." • "Would result in a contractual shadow network – unquantifiable." • "Will lead to a doubling of costs for reconciliations." • "An additional 20-30 FTEs would be needed with potential duplication of effort." • "30% increase in costs." • "We need general standards of safekeeping, custody and liability - would be crazy to apply these to AIFMD but not UCITS."	• N/A
Boxes 90/91: Definition of loss , External event definition (no Options proposed by ESMA)	• "This is a killer for depositaries to have to determine title to the assets." • "We will need an additional 65 people on top of current team of 13 with estimated costs of $6million just for the re-papering of contracts." • "We will end up exiting certain markets or having to synthetically trade there and we'll have to significantly increase our network team." • "Our offering would be scaled down and there would be some clients that we would have to stop doing business with." • "Depositary won't have access to the right information to determine who has title to the assets." • "Economically impossible – if we take current insurance costs for things such as PI and Criminal Insurance and extrapolate for requirements under AIFMD for custodied assets, you could be looking at insurance costs of hundreds of millions of dollars." • "Need an agreement of precisely when an asset is 'lost'; small changes to the wording could have a huge impact on the places where we would want to do business. The problem is also precisely when and how an asset is valued?" • "There is too much to play for in the legal definitions before we can even start thinking about costs." • "Regarding discharge of liability for example if the Depositary sees political unrest in Greece, should it take action to tell Fund Board to reduce positions or inform Regulator and thereby 'get out' of liability at this risk of interfering with Fund's investment strategy?"		

	• "If PBs provide the execution, normally the assets are with the executing brokers - latter recognised as highly volatile, poorly capitalised organisations." • "Big battles expected as to whether assets are really ever 'lost'; this isn't just a Y/N issue as the arbiter has to be via the courts and this will take time; the return of a like asset (settled in cash) depends on the precise point when the valuation is done. It's not desperately difficult to work out but there might be some disparity, especially for non-fungible instruments. Treatment of the 'loss' must also extend to include when the loss is truly permanent." • "Our concerns have decreased somewhat; there is clearer text around the liability provisions now; we were worried that depositories were being positioned as de facto insurance providers."

iii. Respondents' assumptions

Please refer to Appendix (Section V.iii) for ESMA questions on Cash Monitoring, Safe-Keeping and Definition of Loss/Liability

Current scenario assumptions	***Scenario 1 assumptions***	***Scenario 2 assumptions***	***Future state assumptions***
• Current service charge minimums /maximums are pan-European including Ireland, UK, Germany and France and therefore cover jurisdictions which may have very different levels of servicing procedures and associated fee models.	• Under Scenario 1 for 'all-in' impact, respondents have suggested that this could, in certain circumstances be less than the provided estimate range.	• The Scenario 2 Custody services figure does not include cost impact on Prime Brokers who intend to offer Depositary services as their costs may be even higher.	• Because the duties defined in the Consultation Paper are not specific services offered by the Depositary (for example Cash Flow Monitoring or for 'mirroring' of all position transactions), it is not possible to attribute direct cost increases although respondents have suggested 'all-in'/bundled fee increases as a result of the proposed implementing provisions. • Different depositaries will choose to allocate the uplift costs in different ways across their services depending on their business models so no assumptions are made on post-AIFMD service specific charges. • Respondents assume a significant proportion of capital liability uplift and some operational impact costs are passed on to AIFs but cannot specify exact amounts. • The upper cost boundaries to Scenarios 1 and 2 for 'All-in'

			impacts are unbounded; respondents were unable to quantify given the remaining uncertainty over key issues such as legal interpretation of "external event". • Respondents believe execution fees would increase to an unbounded upper limit if implementing measures resulted in ex-ante requirement for prior consent; respondents agree that the proposals in the Consultation Paper do suggest an ex-poste model. • Respondents consider the loss definition and capital liability made up of 2 factors: 1- liability to replace assets lost or which have never existed (fraud) and 2- the negligence and improper performance of the oversight responsibility.

b. Managers' findings:

i. Cost impact summary:

- The table below identifies the current minimum and maximum servicing charges in basis points for manager respondents of they survey. It also captures the estimated % increases to these services.

- Under the New/Additional responsibilities and associated estimated increases in servicing charges, the full range of responses (from 0%-to100%+) are given in order to highlight the extent of differing views. The modal response to these questions is also highlighted.

- The table is different to the order as per the Depositary respondents' table due to the services received today primarily from their prime brokers rather than a Depositary-type institution; as a result servicing fees are bundled differently to that of the core services that Depositary respondents have identified.

		Current State		Future State	
		Avg Service Charges In Bps		Expected % increase in service charges	
		Min	Max	Min Range	Max Range
Services impacted	a. Execution, Financing, Settlement services	5	20+	0-20%	>100%
	b. Custody services	2	8	0-20%	>100%
	c. Collateral Management services	5	15	0-20%	>100%
	e. Trustee/Depo bank services	2	6	0-20%	>100%
	Bundled services	**5**	**20**	**0-20%**	**50-100%**
New/additional responsibilities incurred through AIFMD	Cash Flow Monitoring - intra day	n/a	n/a	0-100% (majority stated "Unknown as yet")	
	Cash Flow Monitoring - monthly	n/a	n/a	0-100%+ (majority stated "10%-20%")	
	Safe Keeping - Depositary ensures procedures in place	n/a	n/a	0-100%+ (majority stated "10%-20%")	
	Safe Keeping - Depositary is mirroring	n/a	n/a	0-100%+ (majority stated "10%-20%")	
	Liability/loss definition	**Unknown/Dependent on outcome of strict liability measures**			
Bundled impact		**Majority of respondents expect new/additional costs to be allocated to custodial services**			
Other services potentially impacted	d. Fund Administration services	10	20	0-20%	50%-100%

Table 2: Current average service charges and estimated impact based on respondents' feedback (AIFM/AIF)

ii. Respondents' feedback to ESMA's specific questions on cost impact:

Manager's feedback:
• "If Article 21 strict liability standard threatened in ESMA Level 2 consultation document is introduced whereby our depositary would be responsible (inter alia) for the insolvency our funds' non-affiliated sub-custodians (i.e. the funds' prime brokers) , we would expect fees to increase to between 1-2% per annum. In that scenario, we would have no choice but to re-domicile our funds to a non-EU jurisdiction." • "In the first instance, we would pass charges onto the fund. We would also consider trading synthetically or potentially exit some markets where we currently trade physical/cash settlement in order to reduce the costs of trading in impacted markets." • "Since Lehmans, the industry has taken significant steps to take responsibility over where assets are at any one time; we are already doing this on behalf of fund investors." • "Depending on the level of the cost increases, we will have to have to pass of these to our investors." • "Custody costs could increase." • "We intend to remain with the National Private Placement Regimes for as long as we can; there is no compelling reason for us to re-domicile." • "If you extend liability so far that clearing/settlement risk becomes impossible to mitigate you are likely to push them [service providers] to move from cash trading to either synthetic trading or completely exit the market – isn't that the opposite of what the Directive is intending?" • "For European funds with a European regulated asset management co, the increase should not be significant except for the custody part, depending on the eventual stance taken by ESMA and the Commission on level 2." • Custodial and settlement charges from Prime Brokers are currently negligible so a small increase would be a large percentage increase. Administration charges are currently more substantial but a 20%+ increase is possible."

c. Implications for the hedge fund industry

Assuming that European hedge fund industry assets under management (AuM) are a proxy for European hedge fund assets held in custody (AuC), which is not a readily available statistic, the estimated additional minimum total costs for European hedge funds under Scenario 1 is estimated to be between at least $0.4bn-$2bn, and between at least $4bn-$6bn under Scenario 2.

Total estimated costs to the hedge fund industry of the strict liability Depositary related implementing measures

European hedge fund industry net assets (as proxy for assets under custody)	*Impact based on Scenario 1 (10-25bps)*	*Impact based on Scenario 2 (>100-150bps)*
*$423bn**	*$0.423bn - $1.057bn*	*> $4.23 - $6.345bn*

**Source: Hedge Fund Intelligence, figure as at 31 Dec 2010*

d. Comparison to other regulatory cost impacts

To provide context to the findings, below are the published cost impact estimates of other recent regulatory developments.

Given the level of uncertainty with regards to Level 2, the total cost to the industry of the AIFM Directive is difficult to quantify. However, based on respondents' feedback, it is suggested that the Depositary liability issue is by far expected to have the greatest cost impact upon the non-UCITS funds industry in Europe.

Directive	Indicative Cost/$bn	Source	Year Published
MiFID	1.6 to 2.4	Accenture	2005
MLD III	1.5 to 2.0	Accenture	2009
AIFMD	3.4 (one-off) 0.27 (on-going) Excludes Depositary liability	CRA	2009
CRD II (Basel II)	5.0 to 5.5	Celent	2010
Solvency II	3.0 to 3.7	Deloitte	2010
RDR	2.5 to 2.6	FT	2011
T2S	0.25 to 0.35	ECB	2011

IV. Suggested further analysis

- Potential considerations on fund revenues and TER: It is advised that further market analysis is needed to understand the impact of the potential servicing cost increases upon investors and what, if anything, they will be prepared to for these additional costs are passed on by the Depositary to its clients.
- Potential considerations on new contractual network from new tri-party relationships: It is also advised that an analysis be undertaken to assess the potential impact of new contractual network that will arise from the new tri-party relationships between Depositary, Prime Broker and AIF/AIFM.
- Potential considerations on the impact of Depositary liability measures on UCITS V: Finally, on the understanding the Depositary liability measures will be 'reversed into' UCITS V, it is advised that an impact assessment be undertaken to assess the impact on the UCITS industry in Europe.
- Potential considerations of the cost impact on the hedge fund industry of other measures such as Leverage, Remuneration and Third Country provisons.

V. Glossary

AIFMD	Alternative Investment Fund Manager Directive
AIF	Alternative Investment Fund
AIFM	Alternative Investment Fund Manager
AIMA	Alternative Investment Management Association
BPS	Basis points
DEPO	Depositary
EMIR	European Market Infrastructure Regulation
ESMA	European Securities and Markets Authority
PB	Prime Broker
NPPR	National Private Placement Regime
OTC	Over-the-Counter
STP	Straight-Through-Processing
UCITS	Undertakings for Collective Investment in Transferable Securities