

13 September 2011

British Private Equity and Venture Capital Association: Response to ESMA's draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive

13 July 2011, ESMA/2011/209

Foreword

The British Private Equity and Venture Capital Association (BVCA) is delighted to have the opportunity to present this submission to ESMA. We believe that the proposals contained within this document should allow regulator and regulated alike to find a structure which ensures renewed confidence in our sector without imposing undue costs or constraining the industry so that it cannot be the engine for economic dynamism in the years ahead that it could and should be. This brief foreword sets out the most important facts about the operation of private equity (PE) and venture capital (VC) in the United Kingdom (the principal theatre for BVCA members), addresses the question of PE and systemic risk and concludes by setting out the advantages for Europe in encouraging a flourishing PE and VC sector.

We note that the attached submission should be read in the context of the submission to ESMA which has been provided by the Public Affairs Executive (PAE) on behalf of the European PE and VC industry. The BVCA has had significant input into the PAE response, and fully endorses the views and suggestions set out in the PAE paper – particularly the drafting suggestions contained within.

PRIVATE EQUITY IN THE UNITED KINGDOM

As the UK is the home and hub for more than half of all PE activity within the EU, it is, unsurprisingly, a significant element in the domestic economy. Private equity funds managed in the UK currently support approximately 4,700 companies, employing about 1.6 million people on a full-time equivalent basis internationally, with slightly more than half that number (810,000) in the United Kingdom. As an illustration of recent activity, in 2010 PE funds managed in the UK invested in more than 1,000 companies, employing over 300,000 full time equivalent individuals worldwide. Once again, a large proportion of those companies are based in the UK and employed slightly more than half of the global total number of people. Of these companies, 65% would be defined by the European Union as “small” and a further 20% would be categorised as “medium” in size. Private equity funds managed in the UK raised £6.6 billion in funds in 2010 (despite this being a challenging year) of which more than half (56%) came from outside the UK. The biggest sources of fundraising in

2010 were pension funds (£1.6 billion), family offices (£1.2 billion) and corporate investors (£850 million).

PRIVATE EQUITY AND SYSTEMIC RISK

In the aftermath of an economic crisis that may still not have run its full course, policymakers at all levels are rightly determined to discover what caused the deep difficulties within the financial services sector, have an urgent need to assess the level of systemic risk that might still reside within the system and have a forceful desire to reshape the regulatory architecture to prevent any repetition of the events of 2007-2009 in the future. These are entirely legitimate objectives. The ambition, though, should be to identify real systemic risk in a surgical manner and then apply the right remedies.

No analysis or study of PE has reached the conclusion that it represents any form of systemic risk to the UK, EU or international economy. Indeed, assessments such as the Delarosiere report point firmly in the opposite direction. Nor is it associated with individual behavioural activities or incentives which might contribute to economic instability in a wider sense. This is because:

- Systemic risk is the chance of an entire financial system failing and reflects the dangers that arise from interlinkages and interdependencies in markets and systems as opposed to isolated risks associated with individual firms or institutions. The failure of Lehman Brothers in the United States was so catastrophic not because it was simply a very large US investment bank in the market but because it was so interconnected with other financial institutions (a fact that politicians and regulators were not in a position to acknowledge or to assess with any degree of precision).
- Private equity (and venture capital) does not in any way exhibit the types of interconnections that are so prevalent elsewhere. Any loss on an individual PE or VC investment does not impose additional losses on other investments in the same fund portfolio (or on other funds). This means that PE and VC are not a source of systemic risk. They make counter-systemic investments, providing a stable long-term platform. **The failure of one private equity investment does not have a contagion or a “domino” effect on other investments and thus does not pose a systemic risk.**
- The scale and character of PE does not bear comparison with other sectors. It is not the case that EU-based PE houses have funds under management or potential liabilities that are close to, let alone massive multiples of, the GDP of nation state members. Private equity firms themselves do not generally carry debt at the fund level. Furthermore, private equity portfolio companies use dramatically less leverage than the financial firms which collapsed or had to be rescued in 2008-2009. **Private equity is not “too big to fail”.**

- Nor do individual financial inducements exist which might prove undesirable for the economy at large. Private equity involves long-term commitments from investors and a long-term commitment to investee companies. There is no equivalent of bonuses paid on the basis of present (possibly inflated) valuations (PE firms only make a reasonable return once a business has been successfully sold and after investors have been compensated) nor is there the chance to engage in anything akin to “short-selling”. **Private equity is not a short-term activity.**

PRIVATE EQUITY AS A EUROPEAN ECONOMIC OPPORTUNITY

Private equity is currently a larger element of the UK economy than it is for the EU economy as a whole. There is no reason, however, to assume that it could not play a wider role right across the EU or any logic as to why the EU should not rival the United States, East Asia or the Middle East for PE investment internationally. Based on the British experience, there are a number of reasons why this should be deemed desirable.

- Private equity is a rare alternative source of capital at a time when the European banking sector remains in turmoil. Private equity funds managed in the UK currently have around £200bn assets under management, including around £70bn in uncommitted capital of which a substantial proportion is destined for deployment in the UK and EU economies. This capital is currently looking to invest in small, medium and larger European businesses which can be improved and grown over time, generating jobs and tax revenues in consequence.
- Extensive research has demonstrated that the rate of corporate failure for PE backed portfolio companies in the UK during the recession was notably lower than for the economy as a whole and that the (inevitable) decline in overall employment was much more modest than for the economy in its entirety. Private equity is also persistently associated with sharp improvements in productivity in the UK.
- Private equity is an immense force for good for investors and hence pension funds. Over the medium to longer term, the industry has continued to outperform other asset classes. Over the past three years, one of the most difficult periods for business, private equity produced an annual return of 6.7% compared with 2.4% for Total UK Pension Fund Assets and 1.4% for the FTSE All-Share. Over a ten year period, this outperformance is even more marked, with returns of 14.6% per annum for private equity, while Total UK Pension Fund Assets and FTSE All-Share generated 4.5% and 3.7% respectively. Similar achievements can be seen in other EU countries where private equity is significant.

The EU economy desperately needs investment capital now and innovation over the decade to come if it is to thrive in a much more competitive world. The BVCA believes that the evidence demonstrates compellingly that both private equity and venture capital can be important actors in

this regard. ESMA now has the opportunity to reduce the overall level of systemic risk in the EU where it exists and to encourage additional enterprise, investment and innovation. In that spirit, we are privileged to provide this submission.



MARK FLORMAN,

CHIEF EXECUTIVE,

BRITISH PRIVATE EQUITY AND VENTURE CAPITAL ASSOCIATION.

Introduction

The AIFM Directive covers a wide variety of fund types, and we welcome the consideration given by ESMA in this consultation paper to the diversity of funds that exist, and to the recognition by ESMA during the Open Hearing that a one-size-fits-all approach is not a feasible solution and that further tailoring is necessary. While the private equity (PE) and venture capital (VC) industry agrees that there is the need for an effective regulatory oversight over the alternative fund industry, we believe that, as provided for in the text of the AIFMD, any such regulatory oversight should be appropriate and proportionate, taking into account the nature, characteristics and activities of the AIFMs and AIFs to which they apply.

We believe that the proposed Level 2 measures not only contain insufficient tailoring for private equity but also go beyond what AIFMD envisages and impose new obligations not provided for at Level 1. Concepts developed for the publicly traded equities markets are being applied to all alternative investment classes. In a number of cases this results in requirements which are hard to make sense of or look to be unworkable.

Further, we note with concern the constrained consultation timescale, particularly given the scale and complexity of the issues being discussed and the measures being proposed. It is simply not possible to identify all the potential issues within the Level 2 drafting in these circumstances. For these reasons we strongly advocate both ESMA and the Commission to remain open to further comments on the Level 2 issues as further discussion on these key issues takes place and the PE/VC Industry is committed to continue to contribute constructively to the process until its very end and to continuously update and supplement its submission as called for at any time.

We note that as a general approach to this consultation response, we have commented both on the questions proposed by ESMA, as well as the draft advice contained within individual boxes. Where we have not responded to either a specific question or box, it is either as a result of our belief that the proposals contained therein are of limited or no relevance to private equity and venture capital, or because we have detailed substantively the same views elsewhere in our response.

As noted in the foreword, the attached submission should be read in the context of the submission to ESMA which has been provided by the Public Affairs Executive (PAE) on behalf of the European PE and VC industry. The BVCA has had significant input into the PAE response, and fully endorses the views and suggestions set out in the PAE paper – particularly the drafting suggestions contained within.

Section III: Article 3 exemptions

As a general comment, we note that our understanding from ESMA's proposals is that references in Article 3(2) of the Directive to AIFs whose assets are managed by the AIFM "indirectly" through a company which is related to the AIFM are only intended to identify the AIF which are truly under the management of the same entity acting as the relevant AIFM, even if the structure interposes a group company (e.g. a letterbox entity). We agree with that approach and think it is helpful to make it clear. Indeed, any other approach would fail to recognise the fact that there will be a single AIFM for each AIF and that there should be no double counting of AuM.

We note that ESMA's advice recognises that AIFM may exclude from the AuM calculation crossholdings in other AIF managed by the same AIFM. We believe that the double counting generated by any other approach would produce inaccurate results which significantly misstate the actual assets entrusted to the management of the AIFM. Indeed in feeder structures where different co-investors join at different levels, the assets under management might be multiplied many times over if each AIF at each level simply had its assets aggregated. We accept that the Directive makes it important that any additional assets acquired by an AIF through leverage are included but it does not follow that assets acquired without leverage should be double-counted.

Box 1: Calculation of the total value of assets under management

We believe that the provisions in Box 1 should elaborate further on the reference in Article 3(2) to management 'indirectly' through 'linked companies,' to make clear that this is intended only to assist in identifying the true AIFM for each AIF even if there are interposed entities.

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?

In principal the requirement to provide a net asset value for an underlying AIF within 12 months of the threshold calculation should be acceptable for all AIFMs to provide. It is common practice for AIFs to have a 12 month accounting period at which point a net asset value will be produced and usually audited. We would recommend that this audited net asset value be used for the purposes of the threshold calculation.

For PE and VC AIFMs in a start up position, it is likely that the AIFs that they manage will have a low net asset value. This is due to the nature of the industry, and reflects that capital will be called from investors as and when investment opportunities arise. Therefore in the early years of an AIF the net asset value may remain relatively low. It is very possible that as at the threshold calculation date the net asset value of the AIF may be nil.

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

As noted above, AIFs within the PE and VC industry usually have a 12 month accounting period agreed with investors. Actual reporting dates vary across all AIFMs and the AIFs they manage. As part of the annual reporting the AIFM will undertake a full valuation of the portfolio, and the AIF financial statements will often be subject to an external audit. The year end financial statements are usually required to be completed within 90 – 120 days of the year end, subject to agreement with investors.

If a single date is chosen it would often not align with the accounting dates used for the audit of the AIF and the underlying portfolio of investments. Mismatches of reporting dates can already be a problem in relation to the provision of accurate and timely financial information. Imposing a generally applicable date for calculation of AuM would greatly increase the difficulty of obtaining net asset values within 12 months of the relevant calculation date.

If an attempt was made to align accounting dates, particularly to the calendar year end, this would create significant pressures in a number of areas. Firstly the pressures on those performing the valuations – both internally and externally – would increase significantly as the entire portfolio managed by an AIFM would need to be valued based on one reporting date. This will lead to a reduction in the available time to value each investment, therefore leading to a less detailed review taking place.

If a single reporting date were required, this would significantly increase cost as AIFMs and external experts will need to employ significant amounts of resource with very high levels of skill at one point in the year, with little additional work for these individuals for the rest of the year. This in turn will lead to an increase in costs and reduction of returns to investors.

We believe these practical issues, along with the likelihood that they would reduce the quality of valuations, calculations and data provided to the regulators, greatly outweigh the notional consistency gained by using a single date for all funds.

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.

It should be noted that in the context of PE and VC, net asset value calculations are of limited importance, since there is no liquid market for the asset class and there are no purchases or redemptions based on valuations.

As noted above it is common practice for private equity and venture capital to have a 12 month accounting period, at the end of which an AIFM will produce audited financial statements for the

AIFs that it manages. As part of this process the AIFM will produce a net asset value for the AIF which will also be subject to an external audit. The use of this net asset value for the purposes of a threshold measure would be reasonable and acceptable and given that this value is usually subject to an external audit would provide the most objective assessment of net asset value.

However, we are conscious that under Article 19 of the Directive AIFM which are subject to the Directive will in any event be required to value the assets of AIF under management and calculate the net asset value per unit annually. AIFMs managing AIFs that are below the threshold should not be subject to more onerous criteria as those within the Directive. Therefore we would suggest that AIFMs managing AIFs under the threshold should carry out a formal net asset value once per annum and monitor this through the proceeding 12 months on the basis of additional investments made less realisations in order to assess if the AuM will exceed the threshold limits.

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 recalculation of the threshold?

Within PE and VC there are broadly three events that may be identified when monitoring the total value of assets under management and necessitate a recalculation of the threshold these are: Additional investments being made increasing the AuM; realisations of investments held reducing AuM; and a significant change in market conditions for a particular investment which may cause the AuM to increase or decrease depending on the nature of events.

A yearly calculation should be more than sufficient where the asset class is illiquid and investments and valuations accordingly tend to be long term in their nature without great fluctuations. If ESMA nevertheless considers that some form of interim monitoring is required during the course of the year; we recommend that:

- the appropriate approach for a PE or VC manager would be to take its last audited/reported figure for AuM, add to that figure drawdowns made for investments and deduct from it distributions paid and writeoffs.
- that interim monitoring exercise should at most be done half yearly.
- the AIFM should not be required to assess market fluctuations or possible changes in the value of individual assets. It is a complex and time consuming exercise to value a PE or VC asset and the valuation reached is of less relevance since the asset will be held for the medium to long term and only actual realisation proceeds are more important.
- Even where a further valuation is obtained for an individual investment in anticipation of a proposed transaction (sale, co-investment etc) we do not believe this should require an interim consideration of the level of AuM and whether the threshold is crossed. Typically such a valuation will be in anticipation of a sale. Either the sale will be achieved – in which case the revised value is

temporary as far as the level of AuM is concerned since a distribution of actual proceeds will follow the sale – or the sale will not be achieved, in which case the reason may well be that the valuation was not one which actual potential purchasers were willing to pay, and so is not a correct reflection of the level of AuM; and

- Accordingly, if any monitoring is to be undertaken during the course of the year it should be confined to real changes to the level of AuM by way of drawdowns and distributions on a half yearly basis. Any further revaluation or recalculation obligation would impose a very significant burden on these small managers - a heavier burden than the equivalent provisions for Directive compliant AIFM - without any significant benefit in terms of either investor protection or systemic risk control.

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

The purpose of Article 61, as agreed during the Level 1 process, is to ensure that certain AIF which do not make further investments after 22 July 2013 and their managers from the scope of the Directive. Given this, we disagree entirely that these AIFs be included for the purposes of calculating the assets under management of an AIFM. We see no justification for reaching a different conclusion for the purposes of calculating the threshold for Directive application, and believe that the proposal under the question goes further than the text agreed at Level 1 of the Directive and is not within ESMA's mandate. Article 61 clearly excludes certain AIF from the Directive and this should be applied consistently throughout the directive. Therefore we strongly disagree with this question.

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?

Private equity and venture capital funds are rarely leveraged.

The advice in Box 1 focuses on the use of a net asset value for the threshold calculation, yet Box 2 and subsequently Box 95 appear inconsistent by requesting a gross method of calculation.

As reflected in paragraph 1 of Box 2, the Directive requires AIFM to include "assets acquired through leverage" when calculating their total AuM. It is not clear whether what ESMA is proposing is the substitution of gross exposure for net asset value whenever the former exceeds the latter, since this is not stated in Box 2. If that is what is intended we do not believe it is necessarily correct to do so.

Leverage is defined in Article 4(1)(v) of the Directive as "any method by which the AIFM increases the exposure of an AIF it manages [...]". The phrase "assets acquired through leverage" is more specific than the definition already agreed and it does not necessarily equate to taking the gross exposure calculated under Box 95 and applying that, rather than the NAV.

In some cases, such as the simple one where the AIF borrows, or guarantees borrowings, to increase the investments made this is likely to be a distinction without a difference. However the calculation of gross exposure is a complex one and we do not think that all the types of exposure covered by it necessarily increase the level of assets under management.

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?

Foreign exchange and interest rate hedging positions are not used significantly within PE and VC for the purposes of trading. Where such positions are taken this is part of the management of the portfolio to protect the value of assets held by the AIF. Therefore the use of hedging does not involve acquiring any additional assets through leverage and should be excluded from any calculation of the total value of AuM

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?

As highlighted above, the proposed requirements in Box 1 fit well with the current practices in use by both PE and VC, and aligning this with the annual reporting process of AIFs is the most practical solution.

Box 2 is less clear and it is unlikely that it will produce consistent and accurate results. The gross exposure method proposed appears to be inconsistent with the net asset value concept of the purposes of AuM. This proposal is also complex and subjective which is likely to be difficult for small managers of the kind envisaged as exempt from the Directive to be able to calculate and apply consistently across AIFMs.

Section IV: General operating conditions

We are in favour of the approach of defining the scope of risks arising from professional negligence. However, the BVCA is concerned that the current scope of risks are too broad and that the AIFM will not be able to purchase professional indemnity insurance ("PII") that meets the level 2 criteria. This will fail to satisfy the Level 1 requirement of providing AIFM with an option of choosing between additional own funds and PII.

We strongly reject the proposed mandatory application of qualitative requirements taken from the "advancement measurement approach" in the Capital Requirements Directive. This is currently only used by the largest global credit institutions, and it is completely inappropriate to apply this to AIFM.

Box 6: Potential risks arising from professional negligence to be covered by additional own funds or professional indemnity insurance

The Level 1 text specifies professional indemnity insurance ("PII") as one of the methods which must be available to AIFM to cover professional liability risks for the purposes of Article 9(7). It therefore follows that the professional liability risks falling within Article 9(7) are limited to those risks which can be covered by PII. This is reinforced by the reference in recital (23) of the Level 1 text to an AIFM being "free to choose" between PII and additional own funds. There will be no freedom of choice if the Level 2 measures impose a set of minimum requirements which the insurance market is unable to supply to an AIFM.

In our view PII is a far better policy instrument to meet the risks to investors from professional negligence than additional own funds. Accordingly we think it vital that ESMA establishes Level 2 measures which allow AIFM to utilise this investor protection mechanism as an alternative to holding additional own funds. One of the reasons for this is that as assets under management vary, the level of own funds will also have to vary. This could place significant demands on the AIFM as the value of its assets under management fluctuates.

We broadly support the approach which ESMA is taking to this issue, which is largely compatible with the principle outlined above. In particular, we welcome the express recognition that the potential liability risks to be covered (i) relate to professional negligence, as provided for in Level 1 and (ii) are the risk of losses arising from the activities of the AIFM for which the AIFM has responsibility. However, we believe a number of changes to the proposed advice in Box 6 are necessary to meet these objectives. We set out below our commentary on this.

The need to consult the EU insurance market

We think it vital that ESMA consults with the EU insurance market in order to establish whether insurers will be prepared to offer policies of the type which will be required by ESMA's proposals. We have spoken to a number of insurance brokers when compiling our response, but have not carried out a detailed analysis of the types or levels of insurance available.

Requirement for a transitional period

We understand that in many member States, PII is not currently available for AIFM. There may be legal or other impediments in those member States from obtaining PII which meets all of the conditions proposed by ESMA. In order to avoid disadvantaging AIFM in these member States, we propose that ESMA apply a transitional period, during which AIFM be required to obtain PII meeting the requirements of Box 6 insofar as they are able to obtain qualifying PII in their member State. This transitional period would need to end after a stated amount of time in order to ensure a level playing field across the European Union, taking into account the degree to which qualifying PII is available or costly to the degree that makes it impracticable to purchase.

We understand that at present there is no EU market (or perhaps a very limited market) for self managed AIF to purchase PII. We recommend that ESMA investigate this with the insurance community and tailor the requirements accordingly in relation to self-managed AIF.

Clarity about what is required

We have consulted a number of member firms as well as insurance industry representatives about the proposals. A common feature of the comments received is that it is unclear exactly how to draft a PII policy in such a way that it is possible to be certain that the policy meets the proposed requirements. We believe that ESMA will only be able to provide this clarity through liaising with the insurance industry. We would of course be happy to provide contacts with whom ESMA could discuss the proposals in more detail.

Part (c) of the definition of relevant persons

PII typically covers the dishonest, fraudulent or malicious acts of the AIFM's directors, officers or employees (or the legal equivalent of these persons). PII would typically also cover secondees providing services to the AIFM who are under the control of the AIFM. However, we are concerned about the proposed scope envisaged by part (c) of the definition of relevant persons. This refers to "a natural or legal person who is directly involved in the provision of services to the AIFM under a delegation arrangement to third parties for the purpose of the provision of collective portfolio management by the AIFM".

The coverage of PII held by the AIFM in respect of the activities of third parties who provide services to AIFM is typically limited to cover areas or activities for which the AIFM has legal responsibility. Liability of an AIFM where it has delegated functions is often determined by whether the AIFM has breached its professional duties when selecting or whilst monitoring the sub-manager. That position is consistent with the duties imposed upon the manager under Article 20(3) of the Level 1 text.

We are concerned that the proposed drafting does not take this issue into account. It implies that an AIFM will be required to purchase PII to cover the negligent acts of any "delegate". We understand from the proposed definition of "delegation" that this would cover any person whom the AIFM has appointed to perform any of the functions in Annex I of the Level 1 text. We do not believe that AIFM will be able to purchase that type of PII cover. Members of the insurance industry that we have consulted with have stated that insurers would argue that:

- this is contrary to established market practice for PII cover across the professional world (not just in the case of PII for AIFM or financial services providers);
- it is unworkable to identify all the potential third parties in question;
- they do not have sufficient information on which to underwrite/price the risk; and
- many of the third parties in question will have their own PII cover.

This issue would be particularly acute for funds of funds if part (c) of the definition of "relevant persons" is to be considered as covering the manager of an investee fund into which a fund of funds managed by an AIFM invests. No insurer would agree to provide cover for the negligent acts of the manager of the investee fund.

We propose as an alternative that the PII should cover negligence by the AIFM in the selection or oversight of third parties. We believe this addresses the policy concern of ensuring that PII covers matters for which the AIFM bears legal responsibility. This approach also addresses the important issue of ensuring that the PII mandated by the Level 2 provisions is of a form which is available for AIFM to purchase.

Paragraph 2(b)(ii) (liability for negligent misrepresentations, misleading statements made to the AIF or its investors by the AIFM or relevant persons) also refers to "relevant persons". Accordingly the same issue arises here: we are concerned that this risk is not covered by PII policies available in the market. Again, we propose the same solution, namely that PII covers the AIFM's negligence in the appointment or supervision of delegates involved in collective portfolio management.

We note that part (b) the definition of "relevant person" covers any natural person whose services are placed at the disposal of and is under the control of the AIFM, and who is involved in the services of collective portfolio management by the AIFM. In a PE context, we understand that this excludes the services of third parties such as lawyers, accountants, financial advisers, IT providers etc. who provide services to the AIFM to assist them with their portfolio management, but are not themselves involved in portfolio management services. It would be helpful if this could be clarified.

We therefore propose that the reference to "relevant persons" is replaced with a reference to "the AIFM's directors, officers or staff".

Paragraph 2(a): Risks in relation to fraud

It would be helpful if the text could recognise the limited extent of cover which PII can provide in relation to fraud, dishonest acts and malicious acts. Such acts may be covered by PII to the extent that the AIFM is vicariously liable for those acts. So, for instance, PII could cover losses caused by a rogue employee who acted without the sanction of senior management of the AIFM and thereby caused loss to the AIF (typically covered by a "Dishonesty of Employees" extension or provision in a PII policy). We understand that not all insurers automatically provide this cover at present.

However, PII would not cover the acts of individuals where these were institutional acts of the AIFM, such as institutional fraud, dishonesty etc. An AIFM whose business model is to operate a pyramid scheme could not claim against an insurance company for the losses suffered by investors in such a scheme - if such a claim were possible, this would cause significant exposure to the insurance sector arising from moral hazard. It is clearly not desirable to introduce requirements which would lead to moral hazard in the insurance sector. In this context, it is relevant to recognise that a PII insurance policy is principally intended to protect the AIFM against its legal liability - this is an important distinction as it requires the insured entity to have acted in a bona fide manner and for legal liability to exist. It cannot be said that PII is a back to back guarantee to investors (who are in fact only a third party in the context of the policy).

In a different scenario, if an AIFM caused an AIF to invest in a pyramid scheme as a result of having negligently failed in its duties to manage the fund properly, or in the unwitting absence of sufficient due diligence, the legal liability of AIFM for losses arising from that investment should be capable of being covered by PII since such liability arises from (unintentional) negligence rather than fraud.

As noted above, PII is triggered only by the establishment of legal liability on the part of an AIFM to a third party. This cover is sometimes augmented by the purchase of Crime insurance which typically covers the physical loss of assets held in the control or custody of the AIFM arising from fraud, including computer misuse, committed by employees or third parties. Crime cover is likely to be of more relevance where the AIFM acts as custodian of investor money, as opposed to those AIFMs which delegate movement of investor money to a third party financial organisation. However this type of insurance is clearly beyond the requirements of Level 1 (which is limited to professional negligence risk).

Paragraph 2(c): Business disruption, system failures, process management

PII does not cover losses caused by business disruption or system failures, including where this is caused by the AIFM's negligence. These issues may be covered by other forms of insurance (e.g. under a property insurance policy). PII covers the AIFM's liability for its wrongful acts committed in the provision of professional and financial services. It does not cover business risks such as business disruption or system failure. These types of losses are generally not due to any wrongdoing on the part of the AIFM but rather are caused by physical risks such as fire or flood, or technical problems leading to systems downtime. To the extent that such losses are insurable they will be covered under property, computer breakdown, and business interruption policies. As Article 9(7) of the Level 1 text is limited to PII cover for professional liability risk, these issues should be excluded from the requirements as outside scope. "Process management" risk would be covered by PII to the extent this relates to a negligent failure on the part of the AIFM, but this would in any case be covered by paragraph 2(b)(iii). As a result, we recommend deleting paragraph 2(c).

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?

As noted above in our commentary on "relevant persons", PII is typically only available to cover the acts and omissions of the AIFM itself and its directors, officers and employees. Where the AIFM/its staff are responsible for appointing, using and monitoring an external valuer, it would be possible for the PII policy to cover negligence by the AIFM/its staff in performing these activities. However, there may be circumstances in which the valuer acts negligently but the appointment and monitoring of the valuer by the AIFM is not itself negligent. As noted above we do not believe that PII cover is currently available to AIFM to cover this type of "vicarious liability" for external valuers. Accordingly, we propose that this provision be clarified.

Box 7: Qualitative Requirements

We were surprised by this proposal, which is derived from the qualitative requirements imposed on banks using the "advanced measurement approach" ("AMA") for calculating their operational risk requirements under Basel II and CRD. We set out our detailed comment in relation to this proposal in our answer to Question 13 below. We advocate deleting this Box in its entirety.

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

We do not believe that relevant income is feasible or practicable when it includes performance fees, given that these will generally be paid towards the end of a fund's life, and are contingent upon the actual realised returns that a fund makes and returns to investors.

Further, we do not agree that the level of performance fee is an appropriate proxy of the risk that an AIF poses – indeed, there is more likely to be an inverse correlation between the levels of the fees (which reflect underlying fund performance) and losses, since in the context of private equity performance fees are based on realised returns to investors.

Box 8: Quantitative Requirements

We believe that Option 1 is the most appropriate option in this instance. We are concerned that Option 2, through its use of relevant income, is basing its proxy of risk on the amount of fees that an AIF receives. We do not consider that the level of fees received is an appropriate proxy to determine the risk of professional negligence posed by an AIFM. Without empirical research to support a particular approach, we do not think it appropriate to impose a requirement based on the level of such fees. Put another way, as investments are sold profitably for cash which is then returned to investors, revenue goes up and risk goes down. Furthermore, inclusion of performance fees as relevant income could result in significant fluctuations in the level of capital required over the life of the fund.

We also note that it is unclear to us how relevant income is to be calculated (there appear to be a wide range of possibilities) and we are concerned that if this measure is used it will give rise to an uneven playing field between different structures and member States.

In addition, we have also asked a number of firms of varying sizes to estimate their requirements under the two proposed options. They have uniformly concluded that Option 1 (based on the use of AuM only) gives a far lower capital requirement than Option 2, though we note that this will nevertheless require a material amount of own funds be held.

We are concerned that no objective rationale has been provided for the level of additional own funds based on AuM: why 0.01% of AuM, rather than 0.001%, or some other figure? We find this deeply troubling. The effect of the additional own funds requirement will be to require the owners of AIFM - typically individuals who are also the senior management of such institutions - to invest their own money into AIFM, which must then be held in cash or near cash and cannot be used as working capital by the AIFM. Investors have not historically required AIFM to have minimum levels of own funds; they have instead often required the owners of AIFM to invest cash into the AIF in order to align their interests directly with those of fund investors. One effect of the own funds requirements will be to decrease the amount of money which is available to individual executives for investment into AIFs, with the consequence of actually reducing the critical alignment between those executives and the AIFs that they manage. If investors continue to require AIFM owners to invest in the funds in this way, the effect of the own funds requirements will be significantly to increase the cost of founding PE AIFM, which will reduce the number of start up PE and VC AIFM.

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 above we do not advocate using income as a proxy for professional liability risk and recommend deleting this option.

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

We have surveyed a number of our members on this point and illustrate below some example figures illustrating the impact on different sizes of fund. The first column displays the aggregate assets under management of the sample funds, the second two columns display the regulatory capital required to be held under the two options presented by Box 8. AuM numbers are rounded to the nearest €m, options to the nearest €1,000. Where figures were originally supplied in GBP, these have been converted to Euro at an assumed conversion rate of 1:1.

	Aggregate AuM (NAV)	Option 1 additional own funds	Option 2 additional own funds
1.	€7,458,000,000	€746,000	€2,435,000
2.	€6,293,000,000	€629,000	€2,092,000
3.	€721,000,000	€£72,000.	€232,000
4.	€673,000,000	€67,000	€249,000
5.	€311,000,000	€31,000	€147,000

This table reflects the general feedback from our members which indicates that Option 2 results in a significantly higher requirement.

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?

No. We believe that the material contained in Box 7 should be deleted from the proposed advice to the European Commission.

It is not clear whether ESMA's intention is that this approach should be an optional alternative or an add-on for the largest and most sophisticated AIFM. We strongly oppose making these requirements mandatory for AIFM and we recommend that they be deleted. We have a number of reasons for coming to this conclusion.

First, AMA is used only by the world's largest and most sophisticated banks and investment banks. Those institutions are far bigger than AIFM and have far more sophisticated systems. They also have far more detail regarding operational risk metrics, such as historical loss data. Even though the ESMA proposal represents a simplification of the CRD AMA requirements, we consider that much of this proposal is unsuitable and unworkable for an AIFM. Private equity AIF typically invest in 10 - 15 companies; the data set will simply be too small to generate meaningful data to feed in to the AMA approach. It is also unclear whether ESMA intend that AIFM begin recording this data from 22 July 2013 or whether the requirement to hold such data applies retrospectively.

Our second objection is that AMA relates to an operational risk capital requirement. The Level 1 text of the AIFM Directive does not propose such a requirement. It is illegitimate and inappropriate to introduce one. As noted in paragraph 10 on page 35 of the consultation, operational risk issues are addressed elsewhere in the Directive and the proposed Level 2 measures. We particularly object to the proposed paragraph 8, which could be construed as imposing upon AIFM the equivalent of a "Pillar II" requirement. The Level 1 text makes no mention of such a requirement, and to introduce

such a requirement through Level 2 would in our view constitute an effective rewriting of this part of the Level 1 text.

Third, the AMA concept has so far only been applied to credit institutions and to investment firms which deal on own account or underwrite. Therefore, it is limited to entities which take trading risks on their own balance sheets. AIFM do not do this. AIFM therefore present a completely different type of risk and it does not in our view make sense to apply the AMA policy to meet the risks posed by AIFM.

Finally, we note that operational risk is addressed extensively in other parts of the Level 2 proposals, particularly those relating to risk management and compliance.

Q14: Paragraph 4 of Box 8 provides that the competent authority of the AIFM may authorise the AIFM to lower the percentage if the AIFM can demonstrate that the lower amount adequately covers the liabilities based on historical loss data of five years. Do you consider this five-year period as appropriate or should the period be extended?

We do not consider this appropriate for the reasons given in our answer to Question 13 above. The AMA template should not be used for AIFMs.

Box 9: Professional Indemnity Insurance

We are broadly supportive of the approach taken by ESMA. However, we have a number of specific comments on selected areas.

Paragraph 1(b): Relevant persons

Paragraph 1(b) refers to the liabilities to be covered. These should be restricted to the liabilities of the AIFM. Where the directors, officers or staff of an AIFM cause loss through fraud, dishonesty etc, the AIFM will typically be vicariously liable and the claim on the PII policy will be in respect of this vicarious liability. We note in this context also our response to Box 6, where we believe that the definition of relevant person has been too widely drafted and is not practicable. Accordingly paragraph 1(b) should cover only the liabilities of the AIFM.

Paragraph 1(c): Carve-outs

We have a significant concern in relation to paragraph 1(c) of the proposals. This could be construed as requiring that none of the risks listed in Box 6 may be carved out entirely from a policy; we would have no objection to this type of requirement. However, another interpretation is that PII policies which contain market-standard carve-outs will not meet the requirements for PII policies under the Directive. If this is the intention, it will be impossible for AIFM to purchase compliant PII policies. All PII policies (in common with virtually all other general insurance policies) contain carve-outs in accordance with proper market practice. It is vital that the Level 2 measures reflect this.

Following consultation with the insurance industry, we understand that 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 (amongst 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 1990s a number of policies excluded liability for Year 2000 computing risk.

It is vital both that the Level 2 measures accommodate the need for carve-outs which are customary in the PII 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.

Paragraph 1 (e): Authorised insurers

We believe that the requirements outlined in this paragraph are potentially onerous. It is unclear how the AIFM in this instance assesses “the financial strength of the insurance undertaking as sufficient”, or what level of diligence is required. We believe that it should be sufficient to rely upon the insurance undertaking being subject to prudential standards and supervision.

Paragraph 1(f): Requirement for affiliate to lay-off risk

We do not consider this should be required if the insurer is authorised to transact PII and meets the other criteria in paragraph 1(f). Such an insurer would be required, as part of its compliance with regulatory requirements, to have adequate own funds and technical provisions to meet the risk from insuring the AIFM. A number of EU insurers are investors in PE AIF. It is important that these insurers not be prohibited from offering PII to the AIFM.

Paragraph 4: Review requirement

It is not clear to us from the current proposal to what extent an AIFM is required to keep compliance with all the requirements of Box 9 under constant review. We doubt such a requirement is practical. We therefore support an annual review by the AIFM. Such a requirement is also easier to enforce as it can more straightforwardly be audited by an AIFM's governing board and competent authority.

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.

In its proposals, ESMA has correctly identified that PII policies typically contain limits relating to the maximum permitted amount of insurance per claim and the maximum aggregate claims per year. We welcome this approach. "Claim" in this context relates to a claim which is made by the insured AIFM against the insurer in the event that it has suffered a loss. However that loss may represent an amount paid to multiple investors who have brought a legal action against the AIFM relating to the same default by the AIFM. In other words, a single "claim" for the purposes of PII cover could correspond to an amount paid out to one investor, 30 investors or 100 investors. For this reason, it is important to have a meaningful threshold per claim.

The impact of the proposal in question 15 seems to be to introduce a new concept into PII policies, namely a reference to the number of persons who might bring a claim against the AIFM in relation to a particular matter (i.e. each claimant). We consider there is a material risk that if this is introduced, insurers may seek to apply a separate deductible to the policy in relation to each claimant. This would reduce the amount which AIFM can claim against PII policies and could conceivably result in no recovery being made under such policies. For this reason, we would oppose any changes such as that proposed in paragraph 2 of Box 9.

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

While PE managers must of course act in the best interests of the investors, it is unclear what this wording refers to in a PE context where no trading takes place; it is unclear what would be considered "undue costs". Where the AIFM is acting in good faith and within its authority, we believe that it should not be subject to retrospective claims that it made a poor judgement with respect to the incurrence of fund expenses.

With respect to the obligation to prevent malpractices, it should be noted that PE transactions do not entail any systemic risk and hence could not affect the stability or integrity of the market.

Box 11: Due Diligence requirements

No. 1: Although PE managers of course apply high standards of diligence when making an investment, there is no "right" level of due diligence for a particular investment opportunity and we strongly object to legislation which seeks to impose a prescribed level of due diligence.

AIFM are free to agree with investors what level of diligence they apply or (where their agreement with investors is silent) to apply the appropriate standards in light of their professional judgement. In some cases it may be appropriate to apply less due diligence, for instance where the price for the asset is sufficiently attractive or other safeguards can be obtained, such as contractual protections. Moreover, an investment decision in a PE-context is a very subjective matter. For this reason we do not think it correct to require that a "high" level of due diligence be required in all circumstances: in some cases this will result in the AIF incurring unnecessary additional cost and in other circumstances the time required to perform a high level of due diligence may result in the AIF losing the opportunity to make the investment, particularly when competing against other market participants. We would propose that the level of due diligence undertaken be consistent with the risk management policy for the AIF. We would also recommend deleting the reference to acting in the best interests of the AIF's investors. The AIFM's duties on a transaction are to the AIF, not to the AIF's investors. The Level 1 directive recognises this distinction.

No. 2: Prior to making a commitment to the AIF, investors will review the track record and experience of the AIFM management team to ensure that they have sufficient knowledge and expertise. The fund documentation typically includes language that provides investors with certain rights in case one or more key (normally senior) individuals leave without being replaced by an appropriate person. More importantly, the qualification of the managers of the AIFM is a criterion for obtaining the AIFM license (s. Art. 8(1)c). In order to obtain such authorisation the AIFM must show that it has sufficient qualification and experience. Therefore, it is unclear what additional qualifications would need to be met here.

No. 3: It is unclear what such policies could be for a PE manager. Currently the fund documentation to which the manager is a party defines the investment guidelines.

No. 4 b): Transactions are selected in accordance with the investment guidelines/investment policy defined in the fund documentation together with the "budget" relating to costs and expenses and follow on financing requirements. There is unlikely to be a business plan as such for the AIF, and the AIFM does not guarantee any special returns.

No. 4 c): We are very concerned about a legislative proposal which seeks to define all the risks which need to be considered. This could force AIFM to focus on the wrong risks (e.g. considering risks which are within the list, when these in fact represent a relatively low risk in the transaction, but perhaps failing to consider potentially higher impact risks which are not in the list). We also note that the risks listed are different from the risks which the AIFM is required to consider under Box 29 when defining the risk management policy for the AIF. We propose instead that AIFM be required to consider the risk management policy for the AIF which the AIFM is required to maintain under Box 26.

No. 4 e): It is the performance of the AIF that is being monitored by the AIFM, not the management.

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?

The Level 2 measures refer in some places to the "business plan", in others to the "investment policy". We understand these are references to the same document. We suggest that the term "investment policy" (as contractually agreed with investors in the fund documentation) is used.

For PE AIFs, transactions are selected in accordance with the investment guidelines/investment policy defined in the fund documentation together with the "budget" relating to costs and expenses and follow-on financing requirements. There is unlikely to be a business plan as such for the AIF, and the AIFM does not guarantee any special returns.

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

Under a standard EU PE fund structured as a limited partnership, subscription only occurs upon signing a subscription document. Such a subscription does not result in the issuing of units in the limited partnership; it simply results in the investor becoming a limited partner and committing to subscribe for a maximum stated amount over the life of the partnership.

A limited partner would typically retain a copy of the subscription agreement and the limited partnership agreement. No further documentation is required. There would be no added benefit to a limited partner requiring an AIFM to supply some additional "confirmation" in relation to a subscription. "Redemption orders" do not exist within the limited partnership context as they are closed ended funds.

We recommend that Box 12 be amended to include a statement that where an investor has been provided with a subscription agreement or deed of adherence which states the amount of the customer's subscription in a fund, that this satisfies the subscription requirement.

Some PE funds are structured as publicly traded closed ended companies. In the event that an investor subscribes for newly issued shares from such a vehicle, the process would be handled by the broker responsible for the issue and not the AIFM. The AIFM is unlikely to know the identity of investors in this case. We propose that where a recognised third party performs this function on behalf of the AIF, the AIFM will not be required to do this.

Box 13: Selection and appointment of counterparties and prime brokers

Private equity firms do not use prime brokers and we do not consider these requirements to be generally applicable to this asset class.

It appears to us that the provisions relating to the selection of counterparties do not make any practical sense when applied to this situation, but that the provisions are wide enough to capture it as the vast majority of such transactions will take place outside of a regulated market (and accordingly "over the counter"). We propose to address this by making clear that the counterparty is a financial sector transactional counterparty providing services to the AIF. This point is particularly important given that the current drafting opens the possibility that both the General Partner of an AIF (in the context of a primary commitment) and the seller (in the context of a secondary transaction between Limited Partners) could be seen to be a counterparty in the current drafting, and it would be impracticable for them to meet the requirements laid down in Box 13.

Box 14: Execution of decisions to deal on behalf of the managed AIF

We believe that paragraph 1 should be reworded from "the best interest of the AIF or the investors of the AIF" to "the best interest of the AIF or the investors of the AIF as a whole" so that it is clear that an AIFM is not required to have regard to the individual interests of investors, which could be conflicting.

No. 2 through 5: Whereas for listed securities it can certainly be determined whether the best possible result was achieved, this is not possible for a PE transaction. Valuation of portfolio companies is subjective and depends on a number of variables.

According to No. 6, such requirements shall correctly not apply where there is no choice of different execution venues. Pursuant to explanatory note 21, no choice of different execution venues is given when the AIFM, for example, invests in real estate or partnership interests and the investment is made after extensive negotiations on the terms of the agreement. Hence, we understand that these requirements are not relevant for PE, and would suggest that the text includes an express inclusion to this effect. Explanatory notes 21 and 24 should be amended to state that it should also not be relevant for investments in unlisted companies (not only real estate and partnerships).

No. 6: With respect to investments in real estate or unlisted companies there is no execution venue as such, because transactions are typically executed in the offices of a law firm. Moreover, we understand that PE auctions in an exit process or a purchase auction are not viewed as such "venues". We support the tailoring proposed by paragraph 6.

Box 16: Handling of orders – general principles

This Box does not make sense for PE, where there are no "orders", nor is there trading on a short term basis. ESMA seems to take the same view when it states in explanatory note 25 that *Box 16 shall not apply where the investment in assets is made after extensive negotiations on the terms of the agreement*. However, the text requires an express exclusion to this effect.

Box 18: Inducements

We wholly support the policy of AIFM acting in the best interests of their AIF and not receiving undisclosed payments of a kind which breach that standard. However, the proposed regime would

cover *any payment*, whether or not this is of a kind which could give rise to such a conflict. We believe that is a problem with the existing MIFID and UCITS inducements regimes. This could be remedied in the AIFM Level 2 text by providing that the restriction only applies to payments that give rise to a potential conflict with the AIFM's duty to act in the best interests of the AIF.

We note that the inducements regime has been developed with retail clients in mind; this is the basis of the regime in UCITS and MiFID. We think it wholly inappropriate to apply this to professional client funds. Professional clients are able to negotiate the terms of their funds with the AIFM. Private equity investors demand extensive disclosure from AIFM prior to investing. The inducements proposal goes beyond the requirements of Level 1.

The investor disclosure requirements under 1.(b)(i) should reflect the fact that prior disclosure may have to be general (i.e. it is not always possible to specify amounts or how they will be calculated) even if later disclosure is specific. In the context of a long-term relationship with the AIF, this may be the only practical route for the AIFM. As noted above, the inducements proposal covers all manner of fees paid to or received by the AIFM. Many of these are for inconsequential amounts in the context of the AIF as a whole and investors will be uninterested in being provided with the detail; what they need is to understand the categories of types of fee which may be paid and/or received where this may cause a conflict with their interests. It will be vital that the reference to "essential terms of the arrangements" is interpreted so that a generic disclosure covering the types of fee which may be received or paid is sufficient. Provided that AIF investors are made aware of the kind of payments that may be made/received and are given the opportunity to obtain further detail from the AIFM, then the objectives of the article are satisfied.

A particular area of uncertainty is what a firm must do to satisfy the requirement that the "payment of the fee or commission, or the provision of the non-monetary benefit must be designed to enhance the quality of the service" in 1.(b)(ii), particularly in connection with the receipt of a payment by the AIFM. If an AIFM receives a payment from a third party it is difficult to see how that enhances the quality of service to the AIF. In this case the question is not whether the quality of service to the AIF is enhanced; the question is whether the payment gives rise to a conflict with obligations to the AIF or impairs compliance with the duty to act in the AIF's best interests, for example by inducing an AIFM to place business in a particular direction at an increased cost to the AIF. Accordingly we propose deleting this aspect of the requirement.

It is not at all clear to us how this could apply to self-managed AIF. The conflicts position for these AIF is completely different to externally managed AIF, as the investors own the AIF which is paying/receiving fees, commissions etc. Unless ESMA is able to clarify this issue, we propose that this provision should not apply to self-managed AIF.

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

We strongly oppose both options.

PE funds already have very concrete and efficient fair treatment rules in place. Typically, a fund agreement provides for the so-called "most favoured nations clause" which foresees that all investors

in the fund are entitled to see any side letter arrangements and benefits granted to other investors and to request the same unless they were granted for tax and regulatory reasons and certain other carve outs (e.g. seat in the investor advisory board for the investors with the greatest commitments). Article 12(1) subpara. 2 of the AIFMD will require that this treatment is applied to all PE AIF.

By contrast, the ESMA proposal differentiates between preferential treatment that has an overall material disadvantage to other investors and preferential treatment that has no overall material disadvantage to other investors. In doing so, the ESMA proposal goes beyond the wording of Article 12(1) subpara.2 of the AIFMD. The reference to an "overall material disadvantage to other investors" is problematic because it leaves too much legal uncertainty. A preferential treatment by its nature causes an overall disadvantage to others. ESMA's proposal would require an AIFM to determine which disadvantages are "material". It will not be possible for ESMA to develop a list of "material" disadvantages and in the absence of such a list different AIFM will take different views. We propose that this requirement is deleted entirely.

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

(a): Technically any compensation is of course at the expense of the AIF; hence it must be made clear that this only covers compensation which gives rise to a conflict. The way compensation is structured (i.e. compensation only on committed capital or NAV or balance sheet valuations or invested capital) makes a significant difference on how AIFM structures investments. Structuring of individual investments will depend on the individual circumstances of the business. Again, disclosure of the approval of inducements must be possible during the lifespan of a fund.

(d): Management activities are often carried out for different AIFs to the extent they do not give rise to a conflict which cannot be managed.

(e): Compensation to managers is sometimes paid via separate structures (e.g. carry vehicles); also sometimes break-up or transaction fees paid by portfolio companies may be retained (but set off, as agreed with investors, against management fees) if so foreseen in the fund documentation.

When dealing with conflicts it should be noted that as important as it is to identify and, in certain cases, disclose conflicts to investors, investors may still wish that an AIFM go ahead with certain actions despite such potential conflicts. This element of liberty must remain. For example, sometimes there are potential conflicts of interest in using a specific service provider or person, yet investors may be happy that the AIFM uses such service provider for the AIF, with appropriate safeguards, because they consider such provider or person to be the best. There should remain the complete flexibility to agree with investors upon individual procedures to deal with conflicts prior to them subscribing a capital commitment.

Box 22: Independence in conflicts management

It is important to ensure that the rules are not drafted so broadly that they result in completely paralysing the AIFM's activities. In a small structure, such independence cannot always be achieved;

hence the rules should be limited to conflicts which have not been disclosed and/or approved by the investor advisory board as contractually agreed with investors.

Box 24: Strategies for the exercise of voting rights

The exercise of voting rights in a portfolio company by a PE fund typically does not cause any issues or concerns. If an investment in a portfolio company could give rise to conflicts of interests, such investment would not be made unless the AIFM has complied with the conflict management provisions it has agreed with investors – e.g. the investor advisory committee has approved the transaction. Hence, it is unlikely that the exercise of voting right in a portfolio company would give rise to conflicts of interests. Therefore, the establishment of "adequate and effective strategies" would seem unnecessary here where there is no doubt that voting rights are only exercised for the benefit of the fund. Therefore, the development of such strategies should be required only "where relevant". The proposal as currently drafted is not proportionate.

IV.IV. Possible Implementing Measures on Risk Management

We welcome ESMA's reference to the comment made by many respondents to the call for evidence, that it would present significant challenges for PE firms to separate the risk and portfolio management activities. In our view, risk management is an integral and intrinsic part of the PE business model, portfolio management role and represents good industry practice. It is important that the Level 2 measures do not require firms to introduce policies and procedures which diverge from this good industry practice through the creation of a separate risk management function. We believe there is a significant risk that detailed regulation on the subject may narrow the focus of risk management to only those aspects which can be identified in the compliance matrix generated to comply with the regulations, rather than genuinely monitoring appropriately the risks of the relevant AIF and its investments. We are concerned that an unintended consequence of the Level 2 measures may be to increase risk within AIFs if this is allowed to happen.

We note that ESMA is faced with a difficult task in setting standards for risk management which are appropriate across the alternative investment space. This is not an homogenous industry. A bespoke, functionally and hierarchically independent risk management function may be suitable for AIFM of those AIF which hold large portfolios of investments in regularly traded securities and/or derivatives which are held in the short term with a view to trading. Such a function may be particularly relevant where the AIF is an open-ended fund, where a flood of redemption requests from investors may require the prompt sale of investments in order to meet redemption orders. Private equity and venture capital AIF do not share these characteristics. These AIF will in the majority of circumstances not be exposed to sudden losses in the event of a market downturn, nor will they be exposed to liquidity crises. They involve closed-ended funds investing for the medium term in a small number of privately held companies.

Typically a PE AIF will invest in between 5 and 15 companies throughout its entire life and will hold each investment for a period of 3-7 years. The role of the investment executives and the governing body of such an AIFM is: to carefully select the private (portfolio) company to be purchased; to

negotiate the terms on which the private company will be acquired; to monitor the investment whilst it is held by the fund; to support the governing body of the private company in growing the private company; and to obtain the best possible price for the AIF on sale of the private company. Risk management is exercised through the governing body of the AIFM testing the portfolio management and monitoring of the portfolio companies and rigorously reviewing and testing the reports that they receive from investment executives, including prior to agreeing to recommend any action on behalf of the AIF.

We believe that where an AIFM is part of a firm or group that provides various financial services and operates in different sectors of the financial industry, the use of dedicated members within a specialised team within the firm or group should not be considered delegation of risk management to a third party.

Box 25: Permanent Risk Management Function

We believe that Box 25, together with all the other boxes in relation to risk management, should require the AIFM to take into account the nature, scale and complexity of their business and of the AIF it manages in determining their risk management strategy.

We note that Box 25 is neutral on the identity of the individuals or body which performs the permanent risk management function, and we welcome this approach. We believe that this provides flexibility to PE and VC AIFM when considering the most appropriate person or body to perform the risk management function within their organisation. It is not possible to list all the various structures which may be effective. We merely note below some of the possibilities which we would expect AIFM may consider using, dependent on the nature, scale and complexity of their business:

- appointing a senior manager from within the investment executive team with designated responsibility for the permanent risk management function;
- appointing a senior manager who does not have an investment executive function to perform this role. We note that many smaller AIFM will not have any senior management staff outside of the investment executive function, so that this will not be an option for them; or
- appointing the governing body or a sub-committee of the governing body to perform the permanent risk management function.

We understand each of these options is consistent with Box 25.

Box 26: Risk Management Policy

We welcome the express reference to AIFM taking into account the nature, scale and complexity of their business and of the AIF it manages in connection with this proposal. We expect that PE and VC AIFM will not have functionally or hierarchically separate risk management functions. We believe that such managers will be able to provide a reason for this as contemplated by ESMA's proposal in paragraph 3(e). We note that the equity risk referred to in paragraph 3(b) is unlikely to be relevant to

closed ended funds, and it may be inappropriate for such firms to carry out stress tests in relation to equity issues.

We note ESMA's comment that the risk management policy should take the form of a separate document but, where this is not proportionate, it could form part of other documentation. We welcome this acknowledgement.

We recommend that ESMA retains flexibility to incorporate the risk management policy within other documentation, though we expect that many will develop a separate document. For many AIFM, we would expect that the document will involve writing down a description of the AIFM's existing unwritten risk management practices in a way which references the specific requirements identified by ESMA.

Box 27: Assessment, monitoring and review of the risk management policy

We are concerned that the practical result of the proposals in paragraph 2 will be that competent authorities will receive a large amount of data which is difficult for them to analyse and process. Instead of requiring AIFM to notify the competent authorities of their home Member State of any material changes to their risk management policy, we propose that AIFM shall do this where requested by their competent authority.

Box 29: Risk Limits

Clarification is needed with respect to the exact meaning of the risks listed. We understand that market risk normally relates to general macroeconomic risk (e.g. risk of not being able to exit), credit risk generally to risks in the context of borrowing. With respect to operational risk, we understand that this only covers the general compliance with the fund documentation agreed with investors.

Some of the techniques for measuring and managing risk would not work for a private equity AIF – e.g. modelling, back testing. Whilst we believe that private equity and venture capital AIFM will be able to produce a document addressing some of the risks identified in paragraph 2, we do not believe this will add any value for investors or for competent authorities. We question the practicality of listing the types of risks to be covered in paragraph 2 and propose instead that the AIFM is solely responsible for determining the risks to be covered.

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?

ESMA's advice does not sufficiently take into consideration that many PE fund managers have very small teams, or that all members of the team discharge risk management as an intrinsic part of their portfolio management activities – they do not operate like banks or investment managers of UCITS funds. Often the team consists only of a limited number of principals, whose functions include the

selecting of investment opportunities and making investment decisions, some analysts assisting in the due diligence process and one or two persons assuming back office functions. The proposals as currently drafted are not proportionate, and will be of little if any benefit to investors.

It is certainly impossible to quantify all risks in numbers. Whereas there may be a risk that an investor is in default and unable to meet a capital call upon draw down or a risk that a key principal leaves the AIFM or the risk that there may be few investment opportunities due to a financial crisis. However it is not possible to measure any of these risks in a quantifiable numeric basis. There are no risks arising from information technology errors, no risk of failure in trading, and the risk of fraud is actually very limited: Investors pay their money upon capital drawn down and not all at once at the beginning of the fund. Therefore, it should be clarified that no quantitative measurement is required with respect to investments in unlisted companies.

Q19: ESMA would like to know which types of AIFM will have most difficulty in demonstrating that they have an independent risk management function? Specifically what additional proportionality criteria should be included when competent authorities are making their assessment of functional and hierarchical independence in accordance with the proposed advice and in consideration of the safeguards listed?

As noted above, we think it highly unlikely that any PE or VC AIFM will have hierarchically and functionally separate risk management functions. They will accordingly need to comply with the provisions of paragraph 3 and so it is vital that these are workable for the AIFM industry. As currently drafted, this is not the case, and this is not proportionate.

ESMA's proposal is not tailored for PE or VC firms. It does not take into consideration that PE AIFM often have very small teams; they do not operate like banks or investment managers of UCITS funds. Often the team consists of a limited number of principals and investment executives, manpower is needed to conduct and organise proper due diligence, to monitor investment opportunities, or to monitor and advise portfolio companies. All this serves in the end to improve returns and also to limit risks. Formal independent risk management processes may work for banks and managers of listed portfolios but are unlikely to be appropriate for PE.

Mandating the requirements of paragraph 3 for PE AIFM both directly contradicts the earlier proposals to allow smaller AIFM to run independent risk management functions without hierarchical and functional separation and risks imposing significant additional cost burdens. The unintended consequence of this will be that the cost burdens will either be borne by investors or AIFM will be unable to function effectively and meet the requirements because investors will refuse to meet these additional costs.

We set out below how a PE AIFM might seek to comply with the proposed requirements and explain our proposed amendments:

Paragraph (a)

The data to be considered might include details about the risks relating to a proposed investment opportunity, a proposed sale opportunity, the establishment of a new AIF or a proposed development at a private company owned by an AIF. We believe it should be straightforward for an AIFM to ensure that the data considered by the risk management function is reliable.

Paragraph (b)

Staff performing this function at a PE AIFM will also perform other functions which may include portfolio management. In these cases it will simply not be possible to comply with this paragraph.

Paragraphs (c) and (d)

If the "independent review" could be performed by the governing body or supervising body of the AIFM or by a committee of investors, we believe this would be workable. However, if by "independent review" it is intended that a third party advisor or consultant must be appointed to perform the review, we think that this will give rise to unjustified additional cost which vastly outweighs any benefit to be gained from the review.

It is not clear to us why paragraphs (c) and (d) have been included; this appears to be duplication. We suggest deleting one of these paragraphs.

Paragraph (e)

Segregation of conflicting duties will often not be possible in small AIFM. Segregation will also not be possible where the role of risk management is performed by the governing body. We propose that in these situations, the conflicting duties should be appropriately managed and where appropriate could be disclosed to investors.

Paragraph (f)

We agree that this must be applicable only where proportionate; the vast majority of PE and VC AIFM do not have independent directors.

Box 44: General requirements on procedures and organisation

We welcome the provision in paragraph 1 of Box 44 allowing the AIFM to take into account the nature, scale and complexity of its business and the business of the AIF(s) it manages when complying with the requirements of paragraph 1. We would, however, strongly recommend that this provision be applied more generally to all the requirements proposed in Box 44 and the other Boxes of this Section IV.VII.

As per previous comments, the alternative investment space is not a homogenous industry and ESMA must take into consideration the fact that many, if not most, PE fund managers operate using very small teams. They bear little or no resemblance to banks or investment managers of UCITS Funds. The capital, time and personnel resources of a PE fund manager are often limited and as a result functions are often legitimately intermingled. Segregation of functions is often impossible and unnecessary. The

requirements of this box and the subsequent boxes of this Section IV.VII should therefore only be applied in a proportionate manner, taking into account the size, complexity and nature of the AIF and AIFM in question. In this way, ESMA will be able to ensure that AIFMs and AIFs are appropriately organised, without making it impossible for smaller funds to comply with the proposals and while not diverting significant resources away from other investor critical functions that increase investment performance and limit risk.

Further, we recommend that ESMA retains flexibility to incorporate the policies and other documentation referred in Box 44 within other documentation produced by the AIFM. For many AIFM, we would expect that the documentation will involve writing down a description of the AIFM's existing practices in a way which references the specific requirements identified by ESMA and question whether this diversion of AIFM personnel is in the best interest of investors.

Box 45: Resources

Again, we welcome ESMA's proposal that this provision be applied taking into account the nature, scale and complexity of the AIFM and AIF business. Such a proportionate approach is fundamental to making this type of provision applicable and effective in the PE and VC fund management sphere.

We also note that the provision contains a number of subjective determinations that are to be made without identifying in whose opinion these determinations would be made. We would strongly advise that the reasonable opinion of AIFM itself, with its unrivalled knowledge of the situations at hand, be applied to make these determinations. This would be in line with current market practice in the PE fund management world and consistent with the terms and conditions of the governing documentation of such funds; terms and conditions that come under substantial investor comment prior to investment and provide investor redress where they are not complied with by the AIFM.

Box 46: Electronic data processing

Private Equity AIFM managing AIF which invest in private companies typically record transactions entered into by the AIF in the form of a paper contract. Similarly, the records of commitments made by investors and amounts returned to investors are typically recorded in the form of a paper contract, for AIF structured as limited partnerships. This could be accommodated in the proposal by referring to "systems" instead of "electronic systems". We understand the need for some level of electronic data processing but would remind ESMA that a typical PE AIF will invest in no more than 10-15 companies throughout its entire term (typically 10 years) and will hold each investment for a period of 3-7 years. Furthermore, PE AIFs are commonly closed-ended and do not, bar a number of very limited circumstances that must be approved in advance by the general partner of the AIF, permit investor redemptions. We would therefore suggest that the entirety of these provisions be applied only where relevant and again only in a manner proportionate with the nature, size and complexity of the AIFM and AIF in question.

AIFM of listed AIF will typically not record the identity of subscribers to the AIF, where this is managed by a recognised third party, such as a registrar.

Box 47: Accounting procedures

We broadly agree with the requirements of this Box 47. We would suggest any accounting and policy procedures developed may be allowed to be incorporated within other policy documents produced by the AIFM.

On accounting policy and procedure requirements we would repeat what has been said elsewhere in this response. US investors, including institutions and pension funds, require US GAAP and many EU investors are familiar with its content and format. Providing that the AIFM must prepare two sets of accounts for each investor base is unduly burdensome and US GAAP and non-statutory accounting standards (e.g. widely used industry guidelines) are frequently a more appropriate standard under which to prepare fund accounts in a manner that ensures that investors can access the financial information most material and relevant to them. This is largely the result of both methods (U.S. GAAP and non-statutory accounting standards) allowing the AIFM not to consolidate its fund or portfolio companies in the presentation of accounts. We would argue this makes for a much more helpful breakdown of the AIF and AIFM's financial performance than any accounts prepared on the basis of IFRS or member State GAAP implementing IFRS (which currently require consolidation). Level 1 clearly contemplates that AIFM will retain the flexibility to determine the accounting standards used for an AIF in the AIF's documentation. It is vital that Level 2 preserves this flexibility and we believe it would be helpful to refer to this in the explanatory notes or recitals. We understand that as drafted, Box 47 preserves this flexibility.

We would refer you to our comments on accounting and annual report procedures elsewhere in our responses, including in the section detailing transparency requirements.

Box 48: Control by senior management and supervisory function

Again, we believe that Box 48 (together with all the other Boxes in relation to "Possible Implementation Measures on Organisational Requirements") should require the AIFM to take into account the nature, scale and complexity of their business and of the AIF it manages.

Box 48 is neutral on the identity of the individuals or body which performs the senior management and supervisory functions of the AIFM. We welcome this approach as we believe that it provides flexibility to PE and VC AIFMs when considering the most appropriate person or body to perform these functions within their organisation. Importantly, it allows AIFMs to build on the existing senior management and supervisory functions they may already have in place, rather than having to incur the large costs and divert substantial resources to building alternative and unfamiliar structures that may not be applicable to the PE or VC context.

Box 49: Permanent compliance function

Our comments in Boxes 44 through to 48 are pertinent to our response to Box 49. Any compliance function requirement must be applied in a manner proportionate to the size, nature and complexity of the AIFM in question; the AIFM should be allowed to identify which bodies and individuals should

perform these functions, taking into account the small teams involved and the existing structures already in place.

Of particular concern is the requirement that the compliance function operate independently of the rest of the AIFM's organisation. Although we believe that AIFMs and AIFs maintain robust compliance procedures, these are frequently not totally independent of the investment function performed by the AIFM, including in EU jurisdictions where these entities are currently regulated. This is largely a function of the resources available to the small teams of individuals involved in any one fund and the flat organisational structures developed to facilitate effective communication. AIFMs are not banks or UCITs; they do not maintain the same resources as these larger institutions and should not be required to do so, as has been recognised by ESMA. They do not constitute a systemic risk to the national economies of the EU or the EU economy itself. Insisting on new and separate compliance departments would impose large and unnecessary costs on AIFMs and do little but damage the investor returns that ESMA and the Commission has set out to protect. We accordingly welcome the inclusion of a proportionality test for determining whether the compliance officer role may sit within the mainstream business structure.

Finally, we do not feel a separate remuneration structure for individuals involved in compliance is necessary to ensure objectivity. While accepting that a remuneration structure that is directly and almost universally reliant upon the performance of the funds being monitored may be inappropriate, a blended remuneration of unconnected base salary and indirectly connected remuneration (such as a pooled carry entitlement) would seem both fair and consistent with current industry practice, while minimising any conflict of interest for the compliance team. We would additionally assert that the individuals involved in compliance must be adequately motivated and skilled, with specialist and extensive knowledge of the AIFMs and AIFs they oversee. In order to attract such individuals, we feel it is necessary to provide them with remuneration that is competitive and attractive and not based on criteria distinct from that provided to other individuals operating in the same arena. Once more we recommend the application of the proportionality test to this requirement.

The vast majority of senior managers receive carried interest, including those responsible for compliance issues. This structure fully aligns the interests of investors and senior executives, as carried interest is only paid where cash has been paid out to investors. These structures accordingly do not compromise the objectivity of senior management, and are very different from structures including bonuses calculated on the basis of unrealised valuations over short time periods.

Box 51: Personal transactions

While we broadly agree with the intent of Box 51 we are concerned with the implementation of its provisions. In particular, we are concerned that the provisions proposed by ESMA are extremely expansive and that their scope and scale introduces subjectivity and inconsistency into the application of these rules. We would encourage scaling back these attempts in an effort to maintain certainty and consistency that we believe will, in the end, provide the most valuable method of preventing individuals illegitimately benefiting from a personal transaction.

We are concerned that the proposals are considerably wider than UCITS, due to the wider scope of activities within Annex 1 of AIFMD. The effect of this appears to be that more types of person would be caught within the definition of "relevant person". We are concerned that this definition could be extended to a point where it cannot realistically be policed by the AIFM, to include (by way of example):

- lawyers, accountants and other advisors working on transactions for the AIF, even where these persons are subject to their own professional standards;
- administrators and (possibly) their agents; and
- third party valuers.

The persons listed above are likely to be under their own professional obligations in relation to proper conduct. Requiring such persons to disclose their personal data to AIFM regarding their trading increases the risk of misuse or inadvertent leaks of such data. In some cases, this requirement could conflict with requirements of local law. We would propose that the implementing measures recognise these exceptions to the general requirement.

Extending the requirements to any "other assets" would go significantly beyond UCITS and MiFID. AIFM are prohibited under Level 1 Article 12 from making any disclosures which disadvantage the AIF; the effect of Box 51 is to create the need to build an entire policing architecture around this. This would involve applying public market standards to private investments.

We understand that a number of jurisdictions already treat financial instruments as including "partnership interests"; if the concern is specifically to capture partnership interests, we would propose that this type of asset is specifically added instead of "other assets".

In more detail, we would suggest that a system that notifies individuals of their obligations in respect of personal transactions, coupled with a self-certification system in respect of such transactions, would be an appropriate method of policing the requirements of personal transactions. It is unclear how an AIFM would otherwise enforce the requirements of this Box without diverting substantial resources to background investigations and information monitoring systems. Finally, we would suggest that 4(b)(iii) of Box 51 be deleted as it would be impossible to effectively monitor or prohibit.

Box 52: Recording of portfolio transactions

Much of the information requested in paragraph 2 of Box 52 is not applicable to a PE or VC fund that invests in a small number (e.g., 10-15 over a 3-7 year period) of illiquid assets (such as companies), rather than stocks or other traded units on an exchange. These transactions, by their very nature, are heavily documented by legal and other firms engaged to work on the project and also by the AIFM.

While PE and VC firms would be glad to retain and, where appropriate, provide to regulators such documentation, the provision, as drafted, is inapplicable and irrelevant to PE and VC funds and risks

creating unnecessary bureaucracy and red tape. We would therefore suggest applying this provision only where relevant and carving PE and VC funds out from the current language. We would be content to add additional language referring specifically to PE or VC and requiring the retention of the legal documentation referred to in the paragraph above (e.g., share or asset purchase agreement).

Box 53: Recording of subscription and redemption orders

Private equity and venture capital funds are generally untraded, closed-ended funds with a comparably small number of investors. After an initial subscription period new investors are not permitted to subscribe to the fund, nor are investors able to redeem from the fund, until it is wound up at the end of its term (apart from in the most limited of circumstances). The term of a fund is often 10 years or more.

Subscriptions to (and the very rare redemptions from) such funds are heavily documented by legal teams. Each investor must complete substantial subscription materials that are then held on file by the AIFM at all times. In addition, a register of all investors in the AIF is maintained at all times by the AIFM and often the AIFM must make filings in respect of investors admitted in the jurisdiction in which the AIF was formed.

The requirements of Box 54 are designed for traded and liquid open-ended funds; a model totally different from the static, illiquid investor model employed by PE and VC funds. As such, it is not relevant in the context of closed-ended funds and we request that the requirement either be deleted or closed-ended funds be carved out of the requirements. Again, closed-ended funds, such as private equity and venture capital funds would be happy to have a requirement to retain the types of subscription and redemption documentation referred to above (e.g., subscription agreement, transfer agreement and limited partnership agreement).

Box 54: Recordkeeping requirements

We broadly agree with the provisions outlined in Box 54. As with all other boxes in this section we ask that they be applied in a proportionate way with regard to the size, nature and complexity of the AIFM and AIF in question. Again, we would note that some of the requirements are not relevant to a typical PE or VC AIFM or AIF (particularly in paragraph 3) and would therefore suggest the addition of language that makes it clear that all requirements are only to be complied with where relevant.

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. Such a requirement would be inappropriate in the context of the Directive. Retail clients have a robust and comprehensive complaints procedure enshrined for them already and their redress should only be to the individual portfolio manager who acts for them; in the EU such an entity would be subject to MiFID. AIFMs and AIFs are not accessible to retail clients and should therefore not have to handle any complaints that arise in respect of them. We do not believe that this suggestion is

appropriate and would strongly resist any attempt to incorporate such a mechanism into the Level 2 requirements.

Box 55: Policies and procedures for the valuation of the assets of the AIF

Whilst we agree that the valuation methodology should be identified before an AIFM invests in a particular type of asset for the first time, it would be appropriate for the AIFM's policies and procedures to allow for more than one approach to valuation of a particular asset or type of asset. Specifically, it is likely to be appropriate to adopt different approaches to the valuation of assets of the same legal type (e.g. shares) depending on the commercial nature of the investment and a wide range of other facts and circumstances, for example whether or not there is a public market for them, and the materiality of the asset in the context of the AIF's portfolio. Those facts and circumstances will change over time in relation to any given investment (for example, if a company backed by venture capital moves from its pre-revenue stage to becoming cash generative). For this reason, the IPEV guidelines provide for a number of methods of valuation of private equity / venture capital assets, such as multiples of a company's earnings, reference to the prices of similar transactions, cost of acquisition or investment, or discounted cash flows or earnings.

We are concerned that the second sentence of Box 55, paragraph 2, could be read to require a single approach to the valuation of a specific legal type of asset in all circumstances by the relevant AIFM. We suggest amending the sentence to read: "An AIFM shall not invest in a particular type of asset for the first time unless appropriate valuation methodologies have been identified".

We agree with ESMA's commentary to the effect that an AIFM may need to have different external valuers for one AIF, in order to ensure a proper valuation of all assets. Equally, valuation of certain assets may well be undertaken most efficiently by the AIFM in-house, with perhaps external valuers appointed in relation to certain assets where particular expertise is required.

We believe that the interpretation of level 1 of the AIFMD is that there is not a binary choice between internal or external valuation of AIF assets but that a combination of approaches may combine to form a "valuation function".

It is generally accepted in the PE and VC industry that it should be the fund manager's senior investment professionals who take primary responsibility for valuations (in-house). There are a number of reasons for this.

First, the choice of valuation methodology and the application of it in relation to a unique, illiquid asset requires a significant degree of expert judgement, and the portfolio managers have by far the greatest familiarity with, and expertise in relation to, that asset.

Second, the senior investment professionals are the people entrusted by sophisticated institutional investors with their portfolio.

Third, the risk of conflicts of interest is mitigated by structural arrangements, such as: (a) the decoupling of fees from interim valuations; (b) the fact that those professionals operate generally in

committee; and (c) the fact that there is often formal oversight, questioning and approval of valuations by an investor valuation committee.

We acknowledge that ESMA is not mandated to advise the Commission on precisely what arrangements must be put in place for an AIFM to perform the valuation function itself. However, we refer to our earlier comments in relation to Box 30 and ESMA's question 13 concerning the independence of the risk management function.

We note that, in Box 55, paragraph 4, ESMA recognises the importance of effective exchange of information between the AIFM and an external valuer. We believe that this supports our argument that valuations can be performed properly in-house with significant involvement from the AIFM's senior investment professionals, provided that there are other arrangements to mitigate conflicts of interest.

We believe that, in the circumstances described, and taking a proportionate approach, a private equity or venture capital valuation function should be considered to be "functionally independent" of the portfolio management function.

Box 56: Models used to value assets

Private equity and venture capital fund managers do not routinely use models (as we understand ESMA to use that term) as part of their valuation methodology. Accordingly, we make no comment on this Box.

Box 57: Consistent application of the valuation methodologies

We support the proposals, noting only that there might legitimately be considerable variation between valuation policies and procedures used in relation to several AIF managed by the same AIFM if they have different investment strategies and/or invest in different assets or types of asset.

Box 58: Periodic review of the appropriateness of the policies and procedures including the valuation methodologies

We support the draft advice, save that we do not believe that it is necessary or proportionate to require an annual review of the valuation policies and procedures. Generally a private equity or venture capital fund manager is bound contractually at least to consult with investors when there is a material change to valuation policies and procedures, and is often obliged to obtain investor consent.

Box 59: Review of individual values

We agree that any valuation policies and procedures will require senior management of the AIFM to bring to bear its experience and to apply common sense to identify valuations which are incorrect. However, the proposal in the box could be read to require the AIFM to undertake a separate process of second-guessing its (or its external valuer's) conclusions with respect to valuation in respect of each asset, asset-by-asset. We do not believe that this can be intended.

The IPEV guidelines do make provision for adjustment to NAV best on the "best available information" as at the valuation date, but this is an integral part of the valuation policies and procedures.

Box 60: Calculation of net asset value per unit or share

It is not clear how the concept of a "unit or share" should be applied in the context of AIF which do not issue shares or units such as private equity, venture capital or real estate AIF structured as limited partnerships. In these cases, the investors' interest in the AIF is a bundle of property and contractual rights, labelled a "limited partnership interest". For this reason, it is not meaningful to require the number of units or shares in issue to be verified.

We do not believe that rules concerning the valuation of units or shares should be a material problem in practice providing it is understood that the only issue of (or subscription for) units of closed-ended AIF takes place at the point of acceptance by the AIFM of the commitment by the proposed investor to the fund when, periodically:

- the AIFM draws down on investors' commitments, and requires them to post cash to finance the purchase of assets; or
- there is a distribution of realisation proceeds or other income.

Box 61: Professional guarantees

We agree with ESMA's proposed clarification that a signed letter of representation from an external valuer (addressing the matters specified in Box 61, paragraphs 2 and 3) constitutes a professional guarantee.

Box 62: Frequency of valuation carried out by open-ended funds

Private equity and venture capital funds are almost always closed-ended, so this proposal is unlikely to be relevant to our members. It would be helpful if the body of the proposed advice (as well as its sub-heading) could make explicit that it applies only to open-ended funds

Box 63: Delegation

We note in Box 63 ESMA refers to the delegation of "advisory services." We would like to clarify that where an AIFM instructs an advisory firm it is not delegating this function but seeking additional professional advice in order to carry out its functions. For example, instructing accountants and lawyers in a due diligence process does not involve delegating any functions. This is because a function can be delegated only where the AIFM has responsibility for it in the first place. Instead, these are services which the AIFM has supplied to it. An AIFM does not delegate the role of legal advisor when it obtains such advice from an independent professional law firm.

We further note that there is a clear distinction between matters which are not delegated functions and matters which are delegated functions but which are not critical or important. For instance, the

provision of services such as legal advice or other due diligence services provided in connection with a potential investment by the AIF do not form part of the functions which an AIFM discharges in the course of managing an AIF (see paragraph 3(a) of Box 63). Instead these are services which an AIFM procures for the AIF in order to enable the AIFM to discharge its management functions. We therefore propose that these should not be delegations which would be subject to the requirements of Article 20 whether or not they are critical or important.

Box 64: General principles

We generally appreciate the flexibility ESMA has built in to this advice. However, it must be noted that the AIFM should be able to delegate tasks such as taking portfolio management and risk management decisions as long as senior management retains responsibility for their performance and outcome.

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

In our view, Option 1 and Option 2 are not mutually exclusive. Therefore, we prefer a combination of Option 1 and Option 2 providing (i) a high-level principle based on the UCITS approach and (ii) a non-exhaustive list of objective reasons for delegating tasks which would clarify such principle.

Box 66: Sufficient resources and experience and sufficiently good reputation of the delegate

We propose that the list (which at the moment appears to be definitive and exclusive) should be replaced with an indicative list.

We request again proportionality be applied when considering the size, scale and nature of the AIFM and the identity of the service provider. If the delegate is one of the world's largest financial institutions, or is regulated within the EU, an AIFM with 20 staff should not be required to carry out checks on the qualifications of the board (who may in any case have nothing to do with the service provided to the AIFM).

We also propose that the AIFM should be able to rely on the professional status of the delegate in circumstances where it is regulated within the EU or a third country with similar standards.

We also consider that the requirement in paragraph 4 that there are "no" negative records as currently stated could lead to unforeseen consequences. Two cited examples of relevant records are bankruptcy and insolvency. However, individuals can legitimately become bankrupt or be legitimately involved in a business becoming insolvent. The proposed ESMA drafting does not allow for any value judgement on the part of the AIFM as to whether such a record in fact merits a finding of unsuitability. As drafted, paragraph 4 appears to prohibit AIFM from dealing with organisations which employ such individuals at a senior level. AIFM following such a requirement would expose themselves to anti discrimination law suits in some member states.

Box 67: Types of institution that should be considered to be authorised or registered for asset management and subject to supervision

In Box 67 we believe that other institutions should also be considered to the extent they are subject to similar regulatory requirements under national laws.

Box 68: Prevention of the effective supervision of the AIFM, or the AIFM from acting, or the AIF from being managed, in the best interest of its investors by delegation

We note the AIFMs duties are to the AIF, not the AIF investors. Level 1 of the directive recognises this distinction.

Box 69: Sub-delegation – General principles

In principal we have no objection against the principles involved in this requirement subject to the comments raised regarding boxes 63 - 68.

Box 71: 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

We object to imposing requirements on the AIF at this level, when the agreements at Level 1 only impose the requirements on the AIFM. This clearly goes beyond what is possible for an AIFM, as it cannot control the existence of any kind of relationship between investor and sub delegate. Paragraph 2 appears to ignore that it is rightly accepted that risk management and portfolio management functions cannot always be assumed by independent persons. Hence the same must be true for the sub-delegate. As set out above in a PE AIFM the senior manager supervising the risk manager will also be responsible for certain operating tasks.

We note that paragraph 3 talks about the need by the delegate or sub-delegate to disclose potential conflicts to the AIFM, which in turn 'should disclose them to the investors in the relevant AIF.' There should be no requirement to disclose to the AIF investors if the conflicts are being properly managed by the delegate or sub-delegate and the AIFM is happy with that.

Section V: Depositaries

In addition to our responses to individual boxes and questions in this section, we have a number of overarching points that we feel are pertinent to the general advice that has been proposed on depositaries:

Ex-ante controls

We note with strong concern that in a number of instances, ESMA is proposing that the depositary be required to exercise ex-ante control over the transactions of the fund. This goes above and beyond the agreed text at Level 1, which provides only a monitoring role for the depositary. We therefore request that the text of the advice be amended to make clear that the depositary cannot exercise ex-ante control over the actions of the fund.

Reliance of the depositary on third parties

In a number of places in the proposed Level 2 text, the depositary is required to undertake checks or procedures which would clearly duplicate work already performed by other parties. Examples of this include cash monitoring (box 76), verification of processes and procedures (box 82), valuation (box 84) and application of income (box 87). This duplication would add cost and administrative burden without resulting in any benefit to investors. We therefore believe there is a very strong argument for explicit recognition within the Level 2 text that, in certain carefully prescribed circumstances, the depositary may rely on the work of third parties to fulfil its various verification obligations.

In particular we note that the auditor of an AIF will typically perform procedures in all these areas. The relationship between an entity and its auditor is already subject to very well established regulations and professional guidelines to ensure independence and objectivity. It would seem appropriate for the depositary to be able rely on the functions properly performed by a duly appointed auditor.

We therefore propose that the following text be included in ESMA's submission to the Commission:

"Where the conditions below have each been met, the depositary may rely on the work of a third party in order to fulfil its verification obligations under the Directive:

- (a) In the reasonable judgement of the depositary, the third party is independent of the AIF / AIFM. The existence of regulations or well established professional guidelines requiring such independence, and a confirmation by the third party to the AIF / AIFM that it considers itself independent within the meaning of those regulations or guidelines, should be considered as strong evidence of independence.
- (b) In the reasonable judgement of the depositary, the third party is competent to perform the necessary verification procedures. This judgement will include an assessment of (1) the nature, scale and complexity of the AIF's operations; and (2) the professional standing, size and experience of the third party. The existence of a regulatory framework within which the

third party operates, and the existence or otherwise of any censure of the third party under that framework, will provide strong evidence of professional standing.

- (c) Terms of engagement are agreed between the depositary and the third party, explicitly stating that the depositary may rely on the work of the third party to provide reasonable assurance that the relevant procedure is in place and/or has operated effectively during the relevant period, as appropriate to the nature of the verification work being performed.
- (d) There are no other circumstances of which the depositary is aware which would make reliance on the work of the third party inappropriate.

The depositary retains the right to undertake its own verification procedures where it deems this to be appropriate, even where a third party has been engaged.”

Requirement to look through to underlying activity

Where a depositary has the requirement to verify the ownership of an asset, it should not have to look through to the level of the underlying activity and physically verify the asset. It should instead be required to use the information provided to it in order to confirm the ownership – the depositary is not designed to mitigate the risk of registrars, but rather to verify to the best of its ability the ownership of the asset based on information provided by third parties in accordance with the requirements of the Directive.

Obligation of the depositary to ‘ensure’ various activities

The various requirements that the depositary must “ensure” that activities are carried out by persons other than the depositary should be changed or clarified to make clear that this term is used to mean that the depositary is required to verify, rather than guarantee, compel or procure, that such activities are carried out. If the use of the term “ensure” is not amended or clarified, the depositary will be unable to fulfil its obligation, since it will be required to “ensure” something which is beyond its control.

Box 74: 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.

We agree that it is right that there is no set form of contract with the depositary proposed, but rather a minimum threshold of requirements that should be met in any contract. However, we believe that the information that is proposed to be included in this contract is detailed, and much of it would be better placed in a process note, and is not appropriate for a contract. In particular, we believe that paragraph 13 is not appropriate information to be held within a contract, and believe that this paragraph should be deleted.

We further have concerns at the amount of detail requested in some paragraphs of these requirements – particularly paragraphs 6, 7, 10 and 12. In these instances, we believe that references to ‘all information’ should be replaced with references to ‘all relevant information.’

As a drafting point, we note that paragraph 3 should also refer to Article 21 (12) for consistency.

We agree with ESMA’s proposed advice that there should be no obligation to enter into specific agreements for each individual AIF, but rather that an AIFM should be able to enter into an agreement covering all of its AIFs – this is an important element in making sure that whilst all necessary protections are in place, excessive burdens are not created.

Box 75: Cash Monitoring – general information requirements

We are concerned that the draft advice in this section is creating obligations that go wider than those that are legally enforceable. In particular, where an account is opened in the name of a depositary, the mandate on this account could in many cases immediately be handed to the AIFM. Therefore, the references to the depositary’s ‘consent’ in paragraph 3 of the explanatory text are incorrect. There is no consent involved, as the depositary is unlikely to have control over the account. We believe that this reference should therefore be deleted.

We do not believe that the reference to ‘effective opening’ of an account in the second bullet of Box 75 is clear. Our understanding on this point is that the effective opening refers to the point at which the account comes into active use. If, however, the account were required to be notified to the depositary prior to its opening, then this would not work in practice – as the information required by the depositary could only be gained after the opening of the account.

There is a further issue, in that the advice as drafted creates an obligation on the third party entity where an account is held. Even in the cases where a third party entity would be content to provide this information, which will not necessarily be the case, this adds in an additional cost burden. We therefore recommend that the AIFM should have the requirement to provide this information. We note that this obligation is placed upon the AIFM in the Level 1 text of the Directive.

Box 76: Proper monitoring of all AIF’s cash flows

We believe that Option 2 is the preferable option, as Option 1 would create transaction delays that would have a severe negative impact on the running of an AIF – there is no practicable need for a depositary to act as a central hub, and doing so would create delays that could put AIFMs at a disadvantage compared to other forms of ownership – for instance, where a company is sold at auction.

We do, however, have a number of comments on Option 2. Firstly, we believe that the effective monitoring of cash flows does not require the monitoring of each individual cash flow related to the

AIF – where there may be several hundred bank accounts involved – but rather should reconcile cash balances. This would provide the same level of protection, as the overall cash balance will ensure that individual cash flows are reconciled, but would significantly reduce the cost – indeed, in many cases, the reconciliation of individual cash flows would prove so onerous as to not be possible.

Further, we believe that the current drafting of the reconciliations being carried out at an appropriate interval should be for discussion between the AIF and its depositary – this interval will be different for different types of AIF, and for PE for instance, there may only be one transaction in a given month.

We also note that much of what the depositary is being asked to do is effectively carrying out a controls audit, for which they are not the best placed to do – rather, this should be a job for specialist auditors, who will have experience in such matters.

Box 77: Ensuring the AIF's cash is properly booked

We note that ESMA, as it recognises, is drafting advice on areas that it does not have the remit under Level 1 to put together. We oppose any such moves, and believe there is no legal basis for such action to be taken.

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 this type of proscriptive requirement is feasible in practice. Many AIFs will not open dedicated operating and subscription/redemption accounts, and may have a different system, involving for instance separate accounts for management – therefore this section should be flexible to provide for the different circumstances that may occur in a given AIF.

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

The frequency of reconciliation of cash flows will depend on the individual circumstances of an AIF, and will take account of factors such as the regularity with which they make investments or divestments.

We agree that there is a distinction to be made between types of assets – for instance, a PE fund will typically make a smaller number of acquisitions and divestments, allowing it to monitor its transactions on an ongoing basis, whilst completing a formal reconciliation once a month. The frequency requirement should be flexible to reflect these differences.

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

Given the text as agreed at Level 1 of the Directive, we do not understand the question. We wonder if the intention was to refer in the question to Article 16 of MiFID, in which case there is a problem, as this is a wholly unnecessary reference which will cause confusion and duplication, and goes beyond the provisions as agreed at Level 1 of the Directive.

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

We believe that Option 2 is preferable. As noted in our response to Box 76, Option 1 would introduce significant transaction delays which would have an impact on the commercial running of a fund, without adding significantly to investor protection. It would also introduce additional costs which would be passed through to investors in the form of decreased returns.

Box 78: Definition of financial instruments to be held in custody – Article 21 (8) (a)

We believe that Option 1 is ambiguous and does not provide a natural fit for the types of assets that could be expected to be held in custody, nor does it clearly exclude investments in privately held companies as paragraph 26 of the explanatory text indicates is intended. We believe that Option 2 is therefore preferable, and is clear and defined set of circumstances where financial instruments can be held in custody consistently with Article 21(8)(a).

With reference to the requirement that financial instruments that can be physically delivered to the depositary should be held in custody, we do not believe that this is practicable, and is inconsistent with Option 2, since if this sentence is retained, it appears to require that physical instruments which could be or are held in a settlement system must be held directly by the depositary. This is impractical and unworkable.

The proposed approach to re-use is incorrect. If a depositary has a right of re-use, once such right is exercised, the depositary is holding the relevant assets for its own account, not as custodian, therefore it is not correct to regard the depositary as still holding such assets in custody. Whether any additional protections are appropriate is a separate question, but cannot be addressed by an artificial approach to what is regarded as held in custody.

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

The current wording confuses the question of whether assets are in fact held in custody with the separate question of whether assets should be held in custody, and does not distinguish between collateral provided by a fund to a third party, or provided to a fund by a third party.

Although Option 1 is reasonable, Option 2 and Option 3 would create confusion and would be unworkable, because there is considerable uncertainty regarding whether and when a security

arrangements falls within the meaning of a "security financial collateral arrangement" for the purposes of Directive 2002/47/EC, therefore it would be difficult to establish whether or not Option 2 or Option 3 was applicable. In addition, such a test is too narrow, because in practice collateral assets may not be held in custody even if the collateral arrangement is not a security financial collateral arrangement.

It is suggested that the wording should be amended to read as follows:

"Financial instruments that can be held in custody, as set out in Box 78, are not held in custody by the depositary in circumstances where such financial instruments:

- (i) have been transferred by or on behalf of the AIF to a third party pursuant to a title transfer collateral arrangement as defined in Directive 2002/47/EC on financial collateral arrangements; or
- (ii) have been transferred by or on behalf of the AIF to a third party pursuant to a charge, pledge or similar arrangement.

The first sentence of paragraph 34 of the explanatory text is incorrect. If a depositary has exercised a right of use, it is likely to have obligations to return equivalent assets of the relevant type, but cannot be regarded as still holding as custodian assets which are likely to have been transferred to a third party. The approach for re-use should be the same as for transfers pursuant to a repo transaction.

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

Because of the difficulties with identifying whether a collateral arrangement is a security financial collateral arrangement for the purposes of the Collateral Directive, and because such a category does not cover all types of security arrangement where the depositary will cease to hold the collateral, we believe that reference to such concept is not appropriate.

Box 80: Safekeeping duties related to financial instruments that can be held in custody

We believe that the requirement that financial instruments be registered in segregated accounts could prove onerous, as noted in our response to Question 25 above, and should be removed or clarified.

The requirement that a depositary is required to assess and monitor all relevant custody risks is, in our opinion, too widely drafted, and imposes obligations far beyond the requirements of the Directive at Level 1. Requiring such an open-ended assessment and monitoring is likely to prove unfeasible in practice, and could lead to confusion as to the depositary's duties under the Directive.

In any event, it is unnecessary in view of the liabilities imposed on the depositary. We recommend that the wording of this section is redrafted as follows:

"Safekeeping duties related to financial instruments that can be held in custody

1. To comply with its obligations pursuant to Article 21(8)(a), in relation to any financial instruments which can be held in custody in accordance with Box 78, the depositary should be required to:

(a) ensure that such financial instruments held by the depositary for an AIF are properly recorded in the books of the depositary in a separate account in the name of such AIF; and

(b) exercise due care in holding such financial instruments in custody for each AIF for whom it acts as depositary.

2. Where the depositary has delegated its custody functions in relation to any financial instruments held by the depositary for an AIF to a third party, the depositary shall require such third party to: (a) ensure that such financial instruments held by such third party for the depositary are properly recorded in the books of the depositary in a separate account in the name of the depositary; and (b) exercise due care in holding such financial instruments in custody for the depositary."

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

We believe that Option 1 is the preferable option in this instance. Option 2 would require significant amounts of resource on the part of the depositary in order to effectively mirror the transactions of the AIF, particularly where there are a number of different accounts involved, and would not add to investor protection above and beyond the proposals outlined in Option 1. This in turn will increase the costs to the depositary, which will ultimately be fed through to investors.

As noted at the start of this section, we believe that there are a number of instances where ex-ante control by the depositary is being proposed by ESMA, and we feel that Option 1, subsection i) is such an example. We feel that in this instance, the wording should be amended to make clear that the requirement to inform the depositary of a transaction does not need to be fulfilled until after the transaction has occurred.

Additionally, we do not believe that the additional wording to be inserted in the case of Option 2 being chosen is workable in practice. The depositary would be unable to compel a settlement system to recognise rights of an AIF or AIFM, or to enable the AIF or AIFM to enforce the rights of the depositary against the settlement system.

Further, we believe that paragraph 3(a) should be deleted. If assets were to be registered in the name of the depositary or its delegate, the assets would effectively be held in custody and should be subject to appropriate safekeeping duties. The inclusion of paragraph 3(a) seems to go beyond the

requirements of the Directive as agreed at Level 1. Article 21(8)(b) contemplates that 'other assets' will be subject only to ownership verification and record keeping.

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

We do not believe that there will be any issues in practice in the delegation of safekeeping duties other than custody tasks, as this requirement is functionally very similar to the record keeping duties that a depositary is able to delegate.

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?

This will depend on the commercial relations between the depositary and the AIF, and point i) is unlikely to cause issues in the context of assets that do not have to be held in custody.

Whilst it might be thought that the depositary has more control where it is the registered owner, the issue of control in the context of fraudulent transfer risks is largely irrelevant in a PE investment in a private company context. This is because the investments are "unique" - the shares are not fungible or easily transferable, they cannot just be transferred to anyone, there will be transfer restrictions, board approvals, pre-emption rights etc.

Under current UK law it is not possible to register shares in a name on behalf of another – a person is either the registered shareholder and entitled to dividends etc. or is not.

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

This will depend entirely on the nature of an AIF. For PE, it is unlikely that there would be a need to provide daily reports, as transactions occur on an infrequent basis. In this instance, such daily reports would be undesirable, as they would create an additional burden which would not add any value.

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?

We believe that the costs of Option 2 would be significant, as it would effectively be recreating much of the existing accounts functions of an AIF.

This issue would be exacerbated in the case of those funds which make a higher volume of transactions, such as in the case of FOF – here the costs would be particularly significant, whilst adding no additional value to investors or regulators.

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

We do not believe that this is possible in practice. The depositary will carry out a verification exercise based on the information provided to it – it will not, for instance, be in a position to approach a registrar directly to look at underlying assets.

Reliance by the depositary on information received by the depositary would satisfy the requirement of the Level 1 text under Article 21(8)(b)(i), and anything further would be putting the depositary in the position of having to act to mitigate the risk of other actors such as registrars, which is outside their remit.

Box 82: Oversight duties – general requirements

We note that the text in the second paragraph of this box refers to verification of processes and procedures that are under the responsibility of the AIFM. We believe that this text should refer only to those relevant processes and procedures that are under the purview of the depositary, and the text as currently drafted is too wide.

Box 83: Clarifications of the depositary's oversight duties

We believe that the wording on this should be amended to make clear that the depositary only has this duty where relevant – for instance, in the case of PE, this information would not be provided and is not relevant.

Box 84: Clarifications of the depositary's oversight duties - Duties related to the valuation of shares/units (b)

We believe that in this instance the draft advice is confusing the verification role of the depositary with that of being a second valuer of the fund. The depositary in this instance should be able to rely on the valuation provided by the external valuer of the fund or by the AIFM as appropriate. We refer in this context to our comments on third party reliance at the start of this section.

Box 85: Clarifications of the depositary's oversight duties - Duties related to the carrying out of the AIFM's instructions (c)

We believe that the proposals outlined in Box 85 go further than provided in Level 1 of the Directive and should be deleted. Specifically, the Level 1 text provides that the depositary act as a control function and does not carry out the instructions of the AIFM unless they contradict either national law of the AIFM's rules of incorporation. ESMA's proposals go wider than this and introduce an effective audit function for the depositary. Therefore, we believe that these should be deleted.

Box 87: Clarifications of the depositary's oversight duties - Duties related to the AIF's income distribution (e)

We think that a more accurate formulation would be in paragraphs 1 and 2 to say:

- "1. Ensure, where relevant, that the net income of the AIF has been allocated to and paid to investors in the AIF in accordance with the applicable national law and the AIF rules or instruments of incorporation.
2. Verify the amount of income that was available for distribution, if any, by reference to the audited accounts of the AIF."

Paragraph 3 is not required. We did not agree that items 2 and 3, in particular the reference to the carried interest, are matters for the depositary, these are for the auditors. We would question what action the depositary could take if the auditors have expressed reservations. These matters will be known to the AIFM and its regulator. We consider that these paragraphs as drafted go beyond what is required or permitted by the Level 1 text.

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

We believe that there are a number of instances where the depositary is required to undertake checks or procedures which would clearly duplicate work already performed by other parties. As set out in the introduction to our response on this section, we believe that in such instances, the depositary should be able to rely on the work of third parties to fulfil its various verification obligations.

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 do not believe that this has relevance to PE, though note in this context our response to Box 83, that the depositary should only have the obligation where relevant.

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.

No. As noted in our response to Box 85 above, we believe that the scope of the duties as drafted amounts to the depositary performing an audit function, not the control function agreed in Level 1. Therefore, we believe that this section should be deleted.

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

We prefer Option 1, as we feel that the Level 1 text in this instance provides sufficient clarity, and see no reason to add more detail than set out in Article 21(9)(d).

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

We note that in paragraph 1, the text should be amended to make clear that this should only apply where the depositary is carrying out actions without the instruction of the AIF. Where it is carrying out the instructions of the AIF in good faith, such instances should not lead to the depositary becoming liable for the loss of an asset.

The reference to rigorous and comprehensive due diligence in paragraph 3 should be replaced with a reference to reasonable efforts as per the agreed text at Level 1, the due diligence requirement as currently drafted goes above and beyond the agreed Level 1 text.

We note that many of the proposals in paragraph 3 would involve a depositary acting to mitigate investment risk, and is the same as a form of ex-ante control. In these instances, the requirement should be for the depositary to inform the AIF of external events, not to take action to mitigate such events, where these fall under the category of an investment risk.

We do not agree that an event such as fraud in a sub-custodian should be classed as an internal event, since there is no control function that the depositary can put in place to mitigate such risk – and they are unlikely to be able to place PII in the market to cover such risk. Similarly, third party insolvency should be treated as an external event.

We believe that the proposals under Box 91 are so widely drafted as to make running a depositary impracticable. This will have the knock-on effect of reducing the number of participants in the market, and this lack of competition will not only increase costs to AIFs, but could act to increase the risk in the market.

Box 92: Objective reasons for the depositary to contract a discharge

We believe that Option 2 is preferable, as this adds certainty to both AIFM and depositary, but recommend that point 1 of Option 1 should also be included as an alternative.

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

Box 93: General Provisions on Calculating the Exposure of an AIF

We broadly agree with the general principles around calculating the exposure of an AIF as defined in Box 93. However, we feel that paragraph 7 creates unnecessary uncertainty through its requirement that exposure should be calculated in a conservative manner. This is inappropriate in the context of how a fund works – it is for an individual AIF to decide their exposure based on a commercial assessment of the facts of the situation, and this estimate will accurately reflect the individual circumstances. If a conservative estimate were taken, then this could act to overstate the exposure of the fund. Therefore, we recommend that this paragraph is deleted.

In addition, we recommend deleting the second sentence of paragraph 3 in Box 93, which is not only unnecessary but also imprecise and may therefore give rise to uncertainty in the calculation of exposure.

Box 95: Gross Method of Calculating the Exposure of the AIF

We broadly agree with the method of calculating exposure as defined in Box 95, though believe that this method introduces complexities in the context of PE investments – the method appears to have been formed with reference to hedge funds, which hold assets in a very different way to PE funds.

Our understanding of ESMA's proposed advice is that the intention is to calculate the NAV of the portfolio gross of borrowing, set against the net assets of the fund. Therefore, the net exposure of the fund is calculated.

We note that paragraph 5 of the steps to take in the explanatory notes to this box covers instances where temporary borrowing arrangements are used. We have two comments on this section. Firstly, undrawn commitments are not borrowing arrangements in this context, as they do not increase the exposure of investors – where they remain undrawn there is no impact to investors, and where they are drawn, they act as a capital call to investors, to the extent that they are fully funded by commitments made to the fund.

Secondly, in the case of bridging loans provided to investee companies, which are provided for a short period in order to bridge a specific time frame or reach a specific milestone, such as an IPO. These arrangements are temporary in nature, and should therefore not be included in any calculation of exposure to the extent they are covered by investor commitments. Similarly guarantees given to portfolio companies should not be included in the definition of exposure to the extent that they are covered by investor commitments

We further believe that the reference to revolving credit facilities in the last line of paragraph 5 should be removed. It is commonplace for an AIF to arrange for revolving credit facilities that can be called in the event that bridge financing is required for an individual portfolio company. To the extent that these commitments remain undrawn, they do not act to increase the leverage of the fund, and where they are drawn, they would in practice function in a similar way to bridging loans.

We consider that section 1(a) should read ‘...excluded from the calculation of exposure’, for the sake of clarity.

Box 97: Advanced Method of Calculating the Exposure of an AIF

We believe that for the sake of consistency, the text on leverage taken on through third party structures that is included in Boxes 95 and 96 should be reproduced in Box 97.

Box 99: Exposures involving third party legal structures

We believe that Option 3 is the preferable option, as this most accurately captures the third party structures described in Recital 78 of the Directive. In the context of PE portfolio companies, leverage contained within portfolio companies does not carry the risk of cross-collateralisation, and this situation is captured within all of the options presented. However, Option 3 provides the greatest clarity and certainty, whilst still ensuring that where there is the potential for the cross-collateralisation of leverage to occur, then this leverage will be included in any restrictions. Option 3 should be clarified by the addition of the following wording at the end of the final sentence: “... to the extent that such guarantees or obligations are not covered by investors’ commitments.”

We believe that Options 1 and 2 as presented create legal uncertainty and are not therefore appropriate for use in the Directive. We understand that ESMA is attempting to capture structures where there is an expectation, if not a legally enforceable agreement, that there will be recourse to the AIF which could lead to cross-collateralisation of debt – and that this would remove from the leverage carve-out structures aggressively designed to circumvent the restrictions on leverage. However, we do not believe that such a restriction would be practicable, and would act to increase uncertainty as to whether leverage should be included in restrictions – at what point, for instance, would recourse to the AIF be deemed?

We note that the references to calculation of leverage in the opening lines of each option should read calculation of exposure, to ensure consistency with the advice in the rest of the section.

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?

We do not believe that any further methods should be documented. As noted by ESMA, the list provided in Box 98 is non-exhaustive, and does not preclude other methods of increasing exposure being included within the scope of the advice.

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

As noted in our response to Box 95 above, we believe that there should be a clarification of contingent liabilities in instances where a guarantee is made in the case of a bridging loan or revolving credit facility – to the extent that such facilities remain uncalled or are temporary in nature, they should not be seen to increase the exposure of the fund.

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?

We believe that 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 from the calculation of exposure.

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

We prefer Option 3 because of the clarity and certainty that it provides. As noted in our comments on Box 99 above, whilst we understand the intention of ESMA in the draft advice, we do not believe that the proposals in Options 1 and 2 provide enough legal certainty to be enforceable to any degree. Option 3, however, strikes the right balance between offering certainty and clarity for AIFs, whilst at the same time protecting against leverage that can carry risks of cross-collateralisation.

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?

Recital 78 of the Directive is clear, and we do not believe that it provides any scope that leverage at the level of a third party financial or legal structure controlled by the AIF should be included in the calculation of the leverage of the AIF.

Where third party structures are used to increase the leverage of the AIF in a manner that increases the exposure of the investors, then this should be included within any restrictions on leverage. The third party structures detailed in Box 99 cover those portfolio company structures where leverage is not cross-collateralised and does not increase the exposure of investors.

Section VIII: Transparency requirements

Box 101: Annual Report Definitions

We do not believe this box has particular relevance to the private equity business model, as the terms and conditions that a fund includes in its Limited Partnership Agreement ('LPA') are unlikely to change in the manner described during the life of the fund. Amendments that are made to a fund's LPA require investor approval.

Box 102: General Principles for the Annual Report

We agree that the accounting information contained within individual fund reports should be prepared in accordance with the accounting rules of an individual AIF, taking into account the national law of the home member state.

Box 104: Primary Financial Statements required under Article 22 (2) (a) and (b) of Directive 2011/61/EU

We believe that it is important that, as per paragraphs 8, 9 and 10, there should be flexibility in terms of providing that the AIF is able to remain consistent with the rules of the AIF, as well as the relevant standards within the home member state. Therefore, we believe that the detail included in this advice should be removed, so that there is no specification on what a balance sheet or profit and loss statement looks like – these will be sufficiently detailed in relevant accounting standards.

Box 105: Content and Format of the Report on Activities for the Financial Year

We feel that the forward facing description of principal risks and investment or economic uncertainties that is proposed goes above and beyond the provisions under Level 1 of the Directive – there is no provision or mandate that the report should look at anything other than activities in the previous year. Therefore, we call for this reference to be deleted.

Box 106: Content and Format of Remuneration Disclosure

We believe that paragraphs 5 and 6 go above and beyond the Directive as agreed at Level 1, and should be deleted – paragraphs 1-4 provide all the necessary information required to meet the agreements at Level 1.

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?

As discussed in our response to Box 102, we do not believe that substantive issues will arise as a result of the approach taken, except in those instances where funds use an accounting standard that is not that of their home member state – we believe that sufficient flexibility should be built in in these instances. Funds will have to comply with the national law of their home member state, and the accounting rules that apply to them.

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?

With the caveat that we believe the advice as drafted in paragraphs 5 and 6 of Box 106 go further than the text as agreed at Level 1, and should therefore be deleted, we believe that the advice as drafted by ESMA in paragraphs 1 to 4 is proportionate and contains the appropriate degree of flexibility required to account for different types of AIF.

However, we believe that the costs of adhering to the requirements on disclosure of remuneration will be significant.

Box 107: Periodic Disclosure to Investors

We believe that Option 1 provides the greater balance between maintaining flexibility in terms of providing for the differing requirements of different types of AIF, and the additional burden of this exposure. Therefore we believe that this is the preferable option.

Box 108: Regular Disclosure to Investors

We agree with the proposals on the disclosure to investors, and note that in accordance with Box 99 of the ESMA proposals, a PE fund in which a portfolio company or related third party entity utilises leverage should not be classed as being leveraged for the purposes of the disclosures as set out.

We further note that where further capital is provided to individual portfolio company investments, this should not be classed as a material change for the purposes of triggering an additional disclosure to investors, to the extent that such a provision adheres to the investment mandate of the fund.

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?

Our interpretation of this question is that it refers to additional obligations, rather than additional liability obligations. That being the case, we believe that there will in some instances be additional obligations on the fund, the cost of which may not be seen by investors as appropriate.

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

We agree with ESMA's proposals in this regard. However, we would ask for clarity regarding different classes of share capital being used in the case of a listed PE fund. This is a usual business practice and does not constitute a "special arrangement"

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

As set out in our response to Box 107 above, we believe that Option 1 is preferable, because it provides the flexibility for different types of AIF that is required.

Q68: Do you think ESMA should be more specific on the how the risk management system should be disclosed to investors? If yes, please provide suggestions.

We agree with the proposals as currently drafted by ESMA and believe that they offer the required flexibility to AIFs. Therefore we do not believe that more specific guidance should be published.

Box 109: Format and Content of Reporting to Competent Authorities

We believe that the general disclosure requirements detailed in paragraph 1 of Box 109 should be provided on the same basis as the information provided to investors, and that quarterly reporting is too frequent.

As outlined in the response to Question 71 below, we do not believe that the provision of information under paragraph 1 should be provided within one month of the end of the relevant period.

In addition, we believe that the provisions detailed in paragraph 3 of Box 109 should not be provided on a regular basis, reflecting the Level 1 agreement on this issue in the Directive. We note that the advice that ESMA is requested to provide the Commission does not provide the remit to extend out the regularity of this disclosure. Further, the requirements in these paragraphs are particularly burdensome for funds. For example, they would require a recalculation of the NAV of each individual investment on a quarterly basis. As reflected elsewhere in the Directive, this revaluation is disproportionately onerous for those funds that invest in illiquid, non-tradeable investments, where

market prices are not available - including portfolio company holdings - without adding significantly to the ability of regulators to monitor the actions of funds under their jurisdiction. As a result, we believe that the information detailed in paragraph 3 should only be required to be provided annually.

We also have significant concerns around the proposals outlined in paragraph 5 of Box 109, that would allow regulators to request that funds provide the information outlined on a more regular basis than that required by the Directive. As outlined above, this would lead to significant additional burdens to those funds that were required to report to these regulators. This could lead to significant disparity of treatment across the EU and market distortions.

We are also concerned with the wording of paragraph 8, in the context of third country AIFs. In this instance, it may be interpreted that the AIF would have to make the disclosures to the competent authority of each member state that it markets to, as home member state – leading to a significant duplication of effort to no additional benefit. We believe that this should be clarified to provide the option of making a single disclosure to the member state of reference, who would then be able to share this information with other relevant competent authorities.

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

As set out in our response to Box 109 above, we believe that the information should be provided to regulators with the same frequency that it is provided to investors – namely where there is a material change to the fund. We believe that the information provided in paragraph 3 of Box 109 should be provided annually, as the current proposals go further than the Level 1 agreements with regards to frequency of reporting.

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.

We believe that the template approach will carry significant costs, and there should be further tailoring to different types of AIF. We would call for national regulators to apply flexibility in this regard when implementing the template.

Q71: Do you agree with the proposed reporting deadline i.e. information to be provided to the competent authorities one month after the end of the reporting period?

We believe that the deadline for the reporting requirement in this context should be 4 months, to coincide with the annual report deadline in Article 22(1) of the Directive. If the deadlines for the provision of information are different, then this would lead to an additional unnecessary burden for funds.

In addition, the proposed one month deadline is not a realistic timescale for funds to be able to collate the information that is requested in Box 109. This issue is particularly pertinent in the context of Fund of Funds ('FoF'), which typically report 90-120 days after the end of a period. Any tighter timeframe would not be realistic for these funds, as they would have to collate information from the individual funds in which they invest prior to completing their own reporting. It is not practicable for FoF to comply with the proposed timescale.

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?

We agree that leverage which must be reported on should reflect the definitions of leverage as described in Boxes 95 to 97, taking into account the definition of exposures involving third party legal structures as defined in Box 99.