

ESMA: Alternative Investment Fund Managers Directive

The ABI's Response to ref: ESMA/2001/209

Questions for Consultation

1. The ABI is the voice of the UK's insurance and investment industry. Its members constitute over 90 per cent of the insurance market in the UK and 20 per cent across the EU. They control assets equivalent to a quarter of the UK's capital. They are the risk managers of the UK's economy and society. Through the ABI their voices heard in Government and in public debate on insurance, savings and investment matters.
2. The ABI was formed in 1985 to represent the whole of the industry and today has over 300 members, accounting for some 90% of premiums in the UK. Underpinning their business activities members have assets under management of £1.5 trillion and in addition manage substantial sums on behalf of third parties such as pension funds.
3. The ABI welcomes the opportunity to respond to this Discussion Paper. Our comments are made from the viewpoint of the institutional investor and tackle those points in the paper which are of particular concern to our members.

General Comments

4. As institutional investors, we fully support the objectives of the Alternative Investment Fund Managers (AIFM) Directive to establish a secure and harmonised EU framework for monitoring and supervising the risks posed by AIFMs to investors, other financial market participants and, in particular, to financial stability.
5. However, it is important to note that this Directive is part of a large set of regulations on financial markets (e.g. MiFID, UCITS). It is fundamental that the implementing measures are consistent with these regulations and do not lead to overlapping requirements or significant administrative burden.
6. On remuneration, we are concerned around the proposal for listing the remuneration earned by staff who have a material impact on the risk profiles of the AIFs they manage. Additionally, we believe that the remuneration disclosures should be subject to similar exemptions as are available to firms under Capital Requirements (Directive 2006/48/EC), which effectively allows information that is immaterial, confidential or proprietary not to be disclosed. The implementation of similar exemptions would ensure a level playing field across all firms subject to remuneration disclosures, which was one of the original objectives of the G20.
7. Additionally, unlike under the UCITS Directive, the proposals under the inducements section in this Directive is intended to apply to marketing as well as to management. We believe that this requirement should apply only to marketing by the AIFM or on its behalf. Therefore it would avoid payments to platforms or

intermediaries. The latter would fall under the MiFID inducements rules, which are currently under review.

8. We would strongly caution against introducing onerous requirements for financial guarantees at the outset. The market for professional indemnity insurance for AIFMs is not mature, and we have not seen any assessment made of the capacity of the insurance market to cover the breadth of liabilities currently existing in the market. Our strong preference would be for a light touch approach, at least initially, until research into the market has established that the capacity and competition exist. Insurance markets that are made compulsory by either statute or regulation have suffered from significant problems in the past, in terms of enforcement; claims against uninsured bodies; overly burdensome requirements; and regulatory weakness.
9. On a general level we observe that, in places, proposed advice is worded in a manner compliance with which is impossible to achieve. For example Paragraph 1 of Box 26 requires AIFMs to identify all the relevant risks that the AIF might be exposed to. It is clearly reasonable to expect AIFMs to seek to identify relevant risks to which it is or may reasonably be exposed but it is impossible to know that 'unknown unknowns' have been eliminated. Indeed that language is not consistent with comparable wording used in Box 25 (1). In places, therefore, we suggest some modification of language should be contemplated while retaining the underlying thrust of the advice.

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?

No, this is reasonable.

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

No, we believe AIFMs should be able to use the date most appropriate to them – most likely their own year-end accounting date. A single prescriptive date will also inevitably lead to a significant concentration of workload for the industry at one point in the year, which would increase operational costs.

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.

For many AIFs NAV is appropriate, but the valuation of the assets will follow the methodology set by relevant domestic recognised accountancy standards and we would suggest this should be left to national regulators at this stage.

For closed ended funds an annual NAV calculation will suffice.

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

We consider that the arrangements need to be refined in circumstances where a fund exceeds the threshold purely on account of market growth. A distinction may need to be made between funds that are and are not to remain open beyond the three month deadline.

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

No, if the exemption of the AIF is valid it should not fall inside the calculation.

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?

It is not entirely clear what falls to be included as the assets underlying derivative positions. We are, moreover, concerned that the definition will not be consistent with what investors and industry participants understand by the term 'assets under management' on behalf of investors. This would be misleading. We are also

concerned at the possibility of bringing many smaller AIFs and AIFMs into the Directive on the basis of 'multiple counting'.

This is clearly one of many places within the Directive where a one-size-fits-all approach for leverage calculation is inappropriate given the diversity of and wide differences between types of AIF.

The approach also needs to be consistent with Part VI of this paper, which allows for various options – gross, commitment and advanced method.

Q7: Do you consider that valid foreign exchange and interest rate hedging positions should be excluded when taking into account leverage for the purposes of calculating the total value of assets under management?

Yes, this is especially important for real estate funds that make frequent use of interest rate hedges.

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?

Yes - the requirements are generally appropriate. However, we have the following comments on Box 1:

Paragraph 3: We agree with excluding investment in other AIFs under management by the same AIFM. This is because it is appropriate to take into account the totality of AIF assets managed by any one AIFM when applying the provisions of the AIFMD to that AIFM. With regard to leverage, we would suggest it should not be necessary to look through to the underlying funds when calculating leverage in the investing AIF, provided this does not create any contingent liability at the level of the investing AIF. The cross-reference to Box 95 achieves this.

Paragraph 5: this is too prescriptive:

- First, the requirement to notify the CA of any situation where the total value of assets exceeds the threshold whether it is considered to be temporary or not is too onerous and will result in a great number of notifications which are unnecessary.
- Second, the three-month period in 5b is a very short timescale. Certainly, a much longer time would be necessary to complete the application process, particularly where major structural changes may be necessary. For example, some AIF may not have a depositary, and we assume would have to appoint one prior to applying for authorisation. In view of this, a longer time period is essential. Also, in practice AIFMs are likely to want to wait until the next valuation point to see if a trend is developing (unless there is a material change they are aware of, such as a significant increase in leverage). We would thus suggest a period of either 6 or 12 months.

Additional own funds and professional indemnity insurance

It is essential to note that self-managed AIFs/AIFMs such as UK investment trusts will not have PII cover if they operate with a board of directors that delegates functions to qualified third parties (in accordance with the Directive) and thus do not have employees *per se*.

In such instances, action against the directors of the AIFM would be covered by directors' liability insurance. We thus assume it would be permissible to have directors' liability insurance rather than PII, but would value clarification on this matter.

Box 6

In general we are concerned about the broad scope and lack of clarity around Box 6. AIFMs should be free to determine what their professional liability risks are in the light of their nature, scale and complexity. Indeed, as some insurance policies do not necessarily cover all the risks listed it may be better to avoid a prescriptive list altogether.

We also suggest that the activities for which the AIFM has "legal responsibility" for the purpose of Box 6 should not go beyond those listed at Annex 1 of the directive, as it would be inappropriate to require AIFM to hold funds against any risks which arise from activities outside those which the AIFMD purports to regulate.

Article 9(7) of the Level 1 text requires additional own funds/PII cover for potential liability arising from professional negligence. In order to meet this requirement, we would suggest Paragraph 2 of Box 6 needs to be amended to make it clear that the various risks requiring cover are only those which arise from professional negligence. So, for instance, fraudulent acts by delegates would be covered by crime insurance, not PII. By contrast, if the loss arose due to the negligent appointment of a delegate who subsequently committed a fraud, then that would generally fall within the scope of the AIFM's PII cover.

We agree that the AIFM should have cover for its own negligence with regard to the appointment and/or ongoing monitoring of delegates, but not with regard to the negligent acts of the delegate. This would result in double counting. The more pertinent point would be for the AIFM to ensure that its delegates hold sufficient PII of their own as part of its due diligence process.

At the very least, we would argue that an external valuer should not be included on any list. The AIFM should be liable if it has negligently selected a valuer (e.g. without doing sufficient due diligence), but if this selection has been made on a reasonable basis, with proper checks undertaken, the AIFM should not be liable under its own policy. Instead, if an incorrect valuation gives rise to damages which require restitution the AIFM itself should take the matter up with the valuer, including seeking legal redress if appropriate.

We would also welcome ESMA's acknowledgement that AIFMs may use a combination or blend of additional own funds and professional indemnity insurance – up to and including a 100% coverage via PII. This freedom is particularly necessary for self-managed AIFs/AIFMs for whom the concept of 'own funds' is something of an anathema: because all AIFM capital is AIF capital and because all AIF capital comprises of fund assets that are the sole property of shareholders the concept of 'own funds' as a group of assets distinct from fund assets does not exist for a self-managed AIF/AIFM as it does for a balance-sheet entity like a bank or a stand-alone UCITS management company or AIFM.

Box 7

Again at a general level, while we recognise the incentive associated with collecting and retaining loss data as a means of understanding potential liabilities arising from professional negligence, we feel AIFMs should be free to determine and implement a risk management strategy which reflects their size and internal organisation, and the nature, scale and complexity of their activities.

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?

The proposed liability risks listed in Box 6 go further than Art 9(7) which is limited to professional negligence. The risk of loss arising from dishonest, fraudulent or malicious acts by relevant persons clearly goes beyond this.

For valuation, as for all delegations, the AIFM should be liable if it has negligently selected a valuer (e.g. without doing sufficient due diligence), but if this selection has been made on a reasonable basis, with proper checks undertaken, the AIFM should not be liable under its own policy. Instead, if an incorrect valuation gives rise to damages which require restitution the AIFM itself should take the matter up with the valuer, including seeking legal redress if appropriate.

It would be helpful if ESMA could confirm that firms can arrange to cover these risks from own funds or PII or a combination of both routes.

Paragraph 1 of Box 7 requires that the risk management activities are performed independently. A 'three lines of defence' model is a typical model of risk management, and the primary emphasis needs to be on 1st line management being accountable for identifying, measuring, managing, monitoring and reporting on all risks relevant to the business. The Risk Function should then perform a 'critical friend' role to the 1st line providing objective challenge with Internal Audit providing the 3rd line of defence, through independent review and assessment of both 1st and 2nd line activities.

We consider it important that any drafting permits this. Otherwise, there is a risk that risk management is not embedded in the business's decision making process. Indeed we believe the ESMA advice should specifically support this model.

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

No, nor do we consider performance fees an appropriate proxy for risk levels at a conceptual level.

In the context of a self-managed AIF/AIFM – and with regard to Box 8 - it is also important for ESMA to recognize that the only income received will be from investments and this 'income' will also often be distributed directly to shareholders. The AIFM does not receive income in relation to collective portfolio management activities or from any other source.

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

We consider it both practicable and appropriate to exclude these commissions and fees, and welcome the text of the ESMA guidelines, which specifies that an AIFM also managing UCITS must not take into account income and commission and fees

expenses in relation to those activities. It would be inappropriate and inconsistent with the Directive to require an AIFM to hold additional own funds against any risks which arise from business outside those associated with the AIF.

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 do not have a definite preference.

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

We do not consider there is any need for the AIFM to implement operational risk measurement, management or mitigants which mirror the standards required through the Advanced Measurement Approach of the Capital Requirements Directive.

Not only is there no specific obligation placed on an AIFM to manage operational risk by the Directive, but conceptually such controls are placed by the CRD on deposit-takers because precisely because they are balance-sheet entities that mingle their own and depositors' money. They are simply not suitable for funds or fund management companies.

The standards of operational risk management which are adopted by the AIFM should reflect the risk to which it is exposed, and AIFMs should be provided with sufficient flexibility to implement a risk management solution which is appropriate to the nature, scale and complexity of the AIFM.

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?

Although we agree with the proposal to allow the competent authority to authorise a lower percentage, we would suggest that that an assessment based on a five year historical perspective is too limited.

We therefore suggest that the competent authority 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 three years or more, or where the AIFM has been in existence for less than three years, for data which covers the entirety of its existence as an AIFM.

This retains an incentive for firms to improve standards of risk management, incentivises firms to collect and retain loss data now in order to achieve three years' worth of data shortly after implementation, and also recognises that for some firms it is physically impossible to have collected such data.

We would also kindly request confirmation that AIFMs are only expected to record material losses (as determined in the AIFM's reasonable opinion) in the historical loss database.

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

No, on the grounds that we do not consider the number of an AIF's investors an appropriate proxy for potential liability arising from risks - in the same way we would question the use of performance fees as a proxy.

General principles

Box 13

We are not clear why it is necessary to consider “the full range... of [a counterparty's] services” if a firm is only utilising their execution services and would suggest that consideration is limited to services rendered.

Box 18

We note that Paragraph 30 of the Explanatory Memorandum states that Box 18 applies to marketing and would argue that the scope of this needs to be clarified – as it had to be for UCITS.

Marketing as defined in Article 4 of the Level 1 text means “any direct or indirect offering or placement at the initiative of the AIFM or behalf of the AIFM of units or shares in an AIF it manages to or with investors domiciled in the union”. So this applies only to marketing by the AIFM or by persons appointed by it. Therefore it would appear to catch, for example, payments to a placing agent for an investment trust IPO, but not payments to platforms or independent financial advisers as these latter would fall under the MiFID inducements rules.

We request clarification that the provision of marketing material and assistance to independent advisers, who may or may not make use of this material, will not cause the adviser to be seen as acting on behalf of the AIFM.

With the example of an investment trust's payment agent in mind – but also more generally - there is also a possible difficulty with 1(b)(ii) – i.e. the requirement that the inducement “must be designed to enhance the quality of the relevant service”. We are not sure whether the payment of a placement agent should be understood to enhance the relevant service as much as it is a necessity to the relevant service, as without the placement agent an investment trust is severely limited in its ability to sell shares to investors.

This may be something of a semantic point, but in any case, we would suggest that this is remedied by the inclusion of wording similar to Recital 39 of the MiFID Level 2 Directive into the Explanatory Text, to make it clear that payment of marketing fees/commissions and other services can be regarded as enhancing the service as long as they are not biased.

Q16: Paragraphs 4 and 5 of Box 11 set out additional due diligence requirements with which AIFMs must comply when investing on behalf of AIFs in specific types of asset e.g. real estate or partnership interests. In this context, paragraph

4(a) requires AIFMs to set out a ‘business plan’. Do you agree with the term ‘business plan’ or should another term be used?

We would certainly query the use of the term ‘business plan’ which we think is misleading. The term ‘investment proposals’, ‘investment policies’ or ‘risk appetite statements’ might be more appropriate.

We have no difficulty with the requirements in paragraph 4 of Box 1 but would suggest that ESMA clarify that these are due diligence standards that are applied only where appropriate – i.e. in relation to real estate and private equity vehicles as the Explanatory Text makes clear. In paragraph 4(c) of Box 11 we believe that the wording should be amended to include that this should be completed on a ‘best endeavours’ basis. Otherwise, we are satisfied that meeting the requirements will be a matter of simple good business practice for real estate funds.

This said, the Explanatory Text for Box 11 also indicates that an AIFM must keep records (potentially for five years) of any due diligence carried out for significant investment opportunities which are not completed. We would suggest that this is an excessive obligation, with no consumer or regulatory value and would recommend that it is struck out.

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

The concept of overall material disadvantage is vague and subjective. In our view the Level 1 requirements are sufficient here and there should be no further detail at Level 2.

This notwithstanding, whichever option is adopted, we would argue that any guidance on fair treatment recognises that investors in separate share classes (with specified, but different, rights and entitlements) of the same AIF can be treated differently according to the relevant conditions attached to each share class.

Again, although this consideration is reflected in the Explanatory Text (paragraph 34), we would suggest that the Box also reflects the sense of the Explanatory Text.

Conflicts of interest

In general we support ESMA’s proposed approach to the management of conflicts of interest (subject to the comments below) and particularly the fact that the proposals are largely consistent with those in UCITS and MiFID Level 2.

Box 21

We are concerned that the inclusion of the activities of “delegate, sub-delegate, external valuer or counterparty” as activities over which the AIFM has to retain control, as suggested by paragraph 2(a), seems excessive and disproportionate, and there is no equivalent requirement in MiFID or UCITS.

We assume that the intention is that the AIFM need have regard to conflicts only between itself and these entities, and not have to look through to entities with which its delegates etc have relationships

Box 23

We would ask ESMA to clarify that the disclosure of conflicts of interest as set out in Box 23 constitutes an ongoing obligation to investors rather than a 'point of sale' obligation to customers. AIFMs should remain free to disclose to investors via their annual reports or websites rather than face the burden of disclosing conflicts of interest policies to each customer or potential investor as a pre-contractual obligation.

In any case – and in the context of paragraph 3 in particular - it is worth noting that investment companies already have significant disclosure obligations which can be discharged through website disclosure. For example, the Transparency Directive allows disclosures (including the distribution of the annual report) via a website where certain approvals are secured. These processes are far more workable and proportionate than those envisaged in paragraph 3.

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

We would thus recommend that paragraph 3 be replaced with provisions reflecting the arrangements that are compatible with the existing requirements of the Transparency Directive.

Box 24

We are happy with Box 24's reflection of existing UCITS standards.

The Explanatory Notes suggest that non-exercise of voting rights should only be permitted if this is to the 'exclusive benefit' of the AIF and its investors. We are concerned that this denies the ability of deliberate non-voting where voting would create a conflict of interest would be prevented. There should be no implication that an AIFM cannot, as a matter of general policy, choose not to vote shares.

Risk management

Box 28

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

It is therefore disappointing that the requirements set out in paragraph 3 are themselves disproportionate. It will not be appropriate for all AIFM to undertake all of the measures set out in sub-paragraphs (a) – (f) and we would recommend that paragraph 3 be amended so that the processes set out in sub-paragraphs (a) – (f) are framed as possible measures which an AIFM could adopt to demonstrate that it has complied with the requirements of paragraph 1.

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

We generally agree with the provisions set out in Box 30. We would like to understand who ESMA considers would be deemed "an independent external party", a term used in paragraph 3 (d). We do not consider that it is proportionate to require external auditors to regularly review risk management functions and reliance should be placed on internal audit and compliance functions.

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?

We consider that the smaller AIFMs or AIFMs that invest in more specialist instrument will have the most difficulty, such as real estate and private equity. This is because market data is not as readily available as with more liquid asset classes such as equities and fixed income. In these circumstances, it would not be efficient or necessarily increase investor protection to enforce such separation. Instead, the conflicts that arise from fund managers being involved in risk management are managed through appropriate governance and oversight. Therefore, in such circumstances, AIFMs will need to reply to paragraph 3 in order to meet the requirements.

We therefore feel there is no need for additional safeguards. On the contrary, we would argue that the draft advice included in Box 30 singularly fails to constitute the proportionate approach promised elsewhere. Instead Box 30 sets out an onerous list of conditions (in paragraph 1) which is highly prescriptive and goes beyond that which is required to secure functional and hierarchical separation.

Instead of operating to such a list we would suggest that the AIFM should be required to demonstrate to the competent authority that it has functionally and hierarchically separated the risk management function with the criteria listed in paragraph 1 (a – e) perhaps being used as evidential provisions that can be cited as indicative of an AIFM having achieved suitable arrangements.

We would even suggest that the call for proportionality of paragraph 5 of Box 6 – an AIFM must "*take into account the nature scale and complexity of their business and the AIF it manages*" - should be applied to all the proposed guidance on risk issues, and in particular in relation to the functional and hierarchical separation of the risk management function.

We are not clear what Box 30.1(e) means (i.e. that the separation is ensured up to the governing body of the AIFM): is the intention that there must be a Chief Risk Officer on the Board independent from operating areas? If so, this is unlikely to be met by a number of AIFMs and they will need to rely on the additional safeguards set out in paragraph 3. We would request that ESMA clarifies.

Liquidity management

We welcome ESMA's approach to liquidity management, which, overall, seeks to be flexible enough to cover the diversity of vehicles captured by the Directive.

We raise below some practical points, which we hope will be of help in refining the advice to the Commission and in clarifying ESMA's technical advice.

Box 32

In line with our response to questions 18 and 19 we would advocate that the ESMA lifts its call for proportionality – that the general requirements be “*calibrated in an appropriate and proportionate manner which duly reflects the specific characteristics of the AIF including legal structure and national legislation*” - out of the Explanatory Text (paragraph 12) and enshrine it in paragraph 1 of Box 32.

Paragraph 3(c) – Where an AIF invests in an AIF in respect of which its AIFM is subject to the Directive, we do not believe it should be necessary for the investing fund’s AIFM to “*monitor the approach adopted by the managers of those other collective investment undertakings (‘CIU’) to the management of liquidity, including through conducting periodic reviews, to monitor changes to the redemption provisions of the underlying CIU in which the AIF invests.*” The reason for this is that those AIFMs will be subject to the Directive too.

It would also be helpful if the text of the advice also recognised that the impact of exceptional liquidity conditions that have not been encountered before may be difficult or impossible to predict. Where that is the case, assessment as to impact can only ever be on a best endeavours basis.

Box 33

We believe that the requirement set out in paragraph 3 should be to act in the best interests of the AIF taking into account the redemption policy of the AIF. Investors may differ from each other in their interests and decisions should be guided by the redemption policy of the AIF as set out in the AIF’s documentation.

Box 34

For the same reason, we do not believe that it is appropriate for the box to include paragraph 1 (a) and that it should be deleted. The investment strategy, liquidity profile and redemption policy should be considered aligned with the fair treatment of investors when investors have the ability to redeem their investments in accordance with the AIF’s redemption policy.

Q20: It has been suggested that special arrangements such as gates and side pockets should be considered only in exceptional circumstances where the liquidity management process has failed. Do you agree with this hypothesis or do you believe that these may form part of normal liquidity management in relation to some AIFs?

Whilst we agree that such tools should be only used in exceptional circumstances, we disagree that the use of liquidity management tools means a process has failed. This is especially the case given that events that may have caused the liquidity shortage could be outside the AIFM's control, e.g. market crashes. Therefore, we agree that these should form part of normal liquidity management provided that investors are aware of the liquidity management tools at the manager's disposal.

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

In paragraphs 2 and 3, it states that effective liquidity management policies and procedures need to take into account the liquidity profile of each AIF. We believe that is the liquidity profile that is the outcome of the implementation of the liquidity policy and procedures rather than an input.

As required by paragraph 3(a), AIFMs cannot be certain to maintain an appropriate level of liquidity and can only aim to. An external event such as a market crash or natural disaster could mean that the AIFM has not maintained an adequate level of liquidity due to event that are unforeseen or out of its control.

Mentioned in paragraph 3(d) is the expression 'arrangements and procedures'. We would like to understand how this differs from 'policies and procedures', which is the expression used elsewhere in Box 32.

We would be interested to understand ESMA's intentions regarding record keeping regarding paragraph 3 (d) in order to ensure they are not unduly onerous.

Paragraph 3(f) introduces a strict obligation that liquidity tools can only be employed in disclosed circumstances. Given that AIFM would only ever use such tools when we absolutely thought it was in the AIF investors' best interests, we consider that this may be too strict a requirement. It may therefore be appropriate to permit wider use, subject to competent authority approval.

Paragraph 2 (g) requires the AIFM to monitor conflicts, as well as identify and manage them. We would be interested to understand what ESMA means by monitor in practice? Also, we note that this is greater than MiFID thereby continuing to exacerbate the lack of harmonisation across the EU.

Paragraph 3(i) requires escalation and we would be interested to understand to whom ESMA anticipates the escalation.

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

While we welcome the fact that Box 32 recognises that the obligations applying to leveraged closed-ended AIFs should differ from those relevant for other funds, the text does not say that a closed-ended AIF need not comply with the requirements of paragraph (e) which deals with redemption policies. We anticipate that this is a drafting error as closed-ended funds do not have redemption policies and would seek clarification that this is the case.

Securitisations

The requirements relating to securitisation are broadly comparable with those which have been included within the text of the Capital Requirements Directive (CRD).

Organisational requirements

Box 49

The requirements in 3(a) and (b), which are the minimum to demonstrate an independent compliance function, seem acceptable, and most AIFMs should be able to comply with this standard.

Nonetheless, it would be helpful if the wording in paragraph 15 of the Explanatory Text were included in the Box, relating to the fact that it is not necessary to establish an independent compliance function if such an establishment would be disproportionate.

Box 50

It is not clear whether the audit function may be outsourced. This should be an option.

Box 52

Recording portfolio transactions provides important regulatory information and may help ensure that the interests of investors are upheld. However, the provisions set out in box 52 are overly complex and do not take account of the variety of AIFM that may be required to keep records or the type of asset which they are dealing in – for example, a self-managed AIF/AIFM managing its own money on behalf of its own shareholders.

Also, an AIFM may transact in assets such as property or private equity which do not lend themselves to the recording obligations set out.

We would therefore recommend that paragraph 2 of Box 52 should be made optional and that paragraph 2 (a) – (i) be transformed into evidential provisions that might constitute an indicative list of information which might be recorded to fulfil the requirements of paragraph 1.

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

Box 53

This section fails to recognise that not all AIFs follow a model where the AIFM is responsible for managing subscriptions and redemptions.

For example, in respect of UK listed closed-ended vehicles there is a secondary market in shares which is not managed by the AIFM, therefore this section will be applicable only in very rare instances – e.g. when new shares are issued.

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

No, we should not be required to have complaints handling procedures in place for circumstances where there is investment on behalf of a retail client. As the AIFMD does not give any rights in respect of marketing to retail clients it is disproportionate to impose obligations in respect of when an investment decision is made on behalf of an underlying retail client who will not have a relationship with or be known by the AIFM. Issues surrounding the marketing of these funds to retail investors should be left for domestic regulators to legislate on.

Valuation

Overall we think that ESMA has specified a robust framework for the valuation of the assets of AIF, which can be adapted to the specific characteristics of the diverse types of assets in which an AIF may invest. We are content.

Box 55

Article 19 (10) specifies that the appointment of an external valuer does not alter the AIFM's responsibility for the proper valuation of AIF assets. Where the valuation function is performed by the AIFM itself, paragraph 5 of box 55 requires the AIFM's valuation policies to include additional safeguards over the functional independence of the valuation function. It would be helpful to clarify that such safeguards can include measures in relation to the AIFM's own staff carrying out the tasks associated with the valuation function as well as to circumstances where those tasks have been delegated to an independent third party under Article 20.

Box 60

Paragraph 4 does not seem to recognise that not all AIFs trade at NAV. For instance investment trusts are exchange-traded and will nearly always trade at a premium or discount to NAV.

In terms of Explanatory Text, paragraph 23 states that *"the AIFM is always responsible for ... where appropriate the appointment of an external valuer."* We do not believe this is correct. According to Article 19 (7) *"AIFMs shall notify the appointment of an external valuer to the competent authorities"* and (4) *"AIFMs shall ensure that the valuation function is either performed by an external valuer or the AIFM itself"*. This allows the governing body of an AIF that has appointed an external AIFM also to appoint an external valuer and we would suggest that paragraph 23 is amended accordingly.

Otherwise, we would note that it is helpful that paragraph 24 of the explanatory text states explicitly that *"a third party which carries out the calculation of the net asset value for an AIF is not considered to be an external valuer for the purposes of Article 19 of the Directive, so long as this entity does not provide valuations for individual assets but incorporates values which are obtained from the AIFM, pricing sources or the external valuer(s) into the calculation process."*

Delegation

Box 63

The list of the types of activity which are unlikely to constitute a delegation from paragraph 11 of the Explanatory Text should be included in Box 63. In particular, we feel that IT suppliers and similar support should be clearly designated as providers of 'supporting tasks' in accordance with Recital 22 and not subject to the delegation rules.

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

Box 64

We would suggest Box 64 is qualified so that AIFMs are required to "make reasonable efforts" with regard the general principles.

Where Paragraph 1(h) states that the delegate should *'be instructed by the AIFM how to implement the investment policy'*, we would suggest the wording is altered to make clear that suitable discretion is allowed to the delegate. Naturally, where any aspect of portfolio management is delegated it must be carried out in accordance with the investment policy. This said, the act of delegation will also often give the delegate

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

Box 66

We note that the checks required under this Box 66 go further than those under MiFID and have concerns that it is not actually credible for an AIFM to definitively satisfy itself that there are no 'negative records' regarding the reputation of a potential delegate.

In particular, we would make a couple of points with regard to this requirement:

- First, paragraph 29 of the Explanatory Text is helpful in that it states that this criterion shall be assumed as satisfied in the case of EU authorised firms. There should be a similar extension for third country firms that have equivalent authorisation. Also, this wording should be included in Box 66 rather than in the Explanatory Text.
- Second, there needs to be a flexible and proportionate approach with regard to this provision where firms cannot rely on Box 67 because the activity delegated is not authorisable (which will commonly be the case, for instance, with fund administration services). Paragraph 4 should state that the AIFM should be entitled to rely on written confirmation from the delegate that there are no negative records as set out in that paragraph.

Box 71

Delivering a suitable and proportionate regime should be ESMA's key priority. With this in mind we support the comment in the Explanatory Text for Box 71 which says that functional and hierarchical separation should be calibrated to the nature, scale and complexity of the sub-delegate. Indeed, we would recommend that this principle be included in the draft guidance itself as this will help deliver a proportionate outcome.

We also agree with ESMA's justification for not providing a model agreement as well as with the proposed approach.

Box 73

We welcome ESMA's approach to so-called 'letter box' entities and believe it is sufficiently robust to ensure that AIFMs have adequate resources to supervise delegates, and to retain the powers to take strategic decisions and perform senior management functions, while at the same time giving firms some flexibility with regard to management structures.

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

We have not reached a definite opinion. Option 2 could be thought more helpful in illustrating practical compliance in a non-exhaustive way with the principles outlined in Box 64. However, some of our members prefer Option 1, arguing that Option 2 risks limiting the reasons that could be cited to justify delegation.

Depositaries

Box 74

We support mandatory provisions for the contract. We specifically support item 11 relating to the provision of details of any third party appointed.

However, we believe the following additional elements should be included:

- That the depositary will exercise due care and reasonable skill in performing its duties in accordance with the standards specified in AIFMD and the ESMA advice, and will impose this standard on any delegate and require the delegate to impose the same standard on its delegate and so on down the chain
- That there should be indemnification or insurance arrangements (or any combination) that will adequately protect the AIF against the risk of loss of assets held in accordance with the contract
- That assets will not be subject to any right, charge, security interest, lien or claim of any kind in favour of any sub-custodian or their creditors except a claim of payment for their safe custody or administration]
- That beneficial ownership of the assets will be freely transferable without the payment of money or value other than [for?] safe custody or administration
- That adequate records will be maintained identifying the assets as belonging to the AIF or as being held by a third party for the benefit of the AIF
- That the independent fund accountant will be given access to those records or confirmation of the content of those records
- That the AIF will receive periodic reports with respect to the safekeeping of the assets
- That the depositary should be required to monitor custody risks associated with securities depositaries on a continuing basis
- That a custody risk analysis will be provided to the AIF and the AIFM and that the depositary will promptly notify the AIF or its AIFM of any material change in these risks (see Box 80).

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?

It would be onerous to make the required changes to current practices and procedures with little perceived benefit accruing to investors. Currently it is common practice for the Transfer Agent/Registrar of the AIF to receive/pay out monies in respect of subscriptions/redemptions of units/shares in the AIF and duly record and account to the AIF/AIFM for those transactions. Changing these operational processes to require accounts to be opened at the Depositary would be unnecessary and not lead to any enhancement in investor protection. The same effect could be achieved by requiring the Depositary to ensure that the appropriate checks and controls are in place at the Transfer Agent and that proper recordkeeping and reconciliation procedures are established and working effectively.

Furthermore, not all depositaries have either the regulatory or operational capability to operate such accounts. Even if operated within the depositary group, such accounts are often operated by another group entity.

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

This will depend on the type of AIF. Determinative factors will include the frequency of the valuation of the assets of the AIF and the calculation of the net asset value per share. The frequency of determination of value will depend on the type of underlying assets invested in by the AIF and the frequency of dealing in the units/shares of the AIF by investors.

By way of example, in relation to open-ended AIFs trading on a daily basis, the reconciliation will be daily.

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

We do not see any problems with the requirement to refer to Article 18 of the MIFID implementing Directive.

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

We do not foresee any particular difficulty.

Box 75

So as to be consistent with the general obligation that *“The AIFM should ensure the depositary is provided, upon commencement of its duties and on an ongoing basis, with all relevant information it needs to comply with its obligations pursuant to Article 21 (7) including by third parties ...”*, the third bullet should be limited to all *“necessary”* information rather than *“all information”*.

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

We support Option 2. The duplication of record keeping is not necessary subject to effective systems and controls regarding cash flows to which the depositary should have oversight. Such duplication would be at a disproportionate cost to investors. By the same token, the monitoring suggested in Option 2 would be sufficient to ensure a proper monitoring of all AIF's cash flows

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

We do not have specific cost estimates.

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

We do not have specific cost estimates.

The depositaries are best placed to provide the answer to questions 30 and 31. The costs could be substantial depending on the level of new systems and operational functions that would need to be developed and, as stipulated above, our concern would be that these additional costs would ultimately be borne by the investors in the AIFs for little if any enhanced investor protection benefits.

To take one example, it is easy to imagine how the very high cash-flow accruing to a real estate fund as it collects monthly rent from all of the tenants of all of its properties would be very costly to mirror at the depositary – and with little benefit in terms of investor protection.

Box 78

We agree with ESMA that the type of financial instruments that can be registered in a financial instruments account opened in the name of the AIF in the depositary's books should be limited to transferable securities, units in collective investment undertakings and money market instruments - as set out in MiFID.

ESMA has addressed the issue of instruments registered with the issuer or an agent of the issuer which should not be regarded as being “held in custody” in Box 78 paragraph 3. We agree that it is correct to limit this to instances where the financial instruments are directly registered with the issuer or agent in the name of the AIF. This is linked to Q36 as there are instances where financial instruments are held at the issuer or agent but where the depositary or a delegate is in a position to instruct transfer.

We also agree that any financial instruments that can be “physically” delivered to the depositary should be regarded as being “held in custody” (second paragraph of Box 78).

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

We do not believe that either option 1 or 2 are necessary on the grounds that the addition of either would narrow the scope of the depositary provisions in a way we do not believe was intended at Level 1.

It is unclear what Option 1 is attempting to capture. At the level of the depositary, financial instruments are recorded in the depositary's books and records in the name of the AIF. Directly below the depositary in the custody chain, for instance if a global custodian is appointed, financial instruments may be registered as belonging to clients of the depositary (e.g. “Depositary XYZ Omnibus Client Account”). However, if a further sub-custodian is appointed, financial instruments may be registered with that sub-custodian as belonging to clients of the global custodian (e.g. “Global Custodian XYZ omnibus client account”) thus falling outside the ambit of Option 1.

Perhaps more importantly, Option 1 leaves it open for the depositary to structure the manner in which it holds financial instruments to avoid the provisions of the Directive.

Option 2 also narrows the class of financial instruments to those held on a “register maintained by settlement systems”. Many financial instruments are not held on this basis, but even if the scope were widened to define instruments by reference to a settlement system or a securities depositary this would result in financial instruments from many jurisdictions being excluded where there is no such arrangement – for instance, in Russia and many of the Commonwealth of Independent States (CIS) jurisdictions.

Ultimately, however, we would question the necessity of limiting the scope of the depositary's obligation at all – and thus Options 1 and 2. The depositary should be responsible for all the financial instruments it holds in its custody network (subject to a limited carve-out for assets held directly with the issuer in the name of the AIF) regardless of whether the financial instruments are held on a “register maintained by settlement systems”.

Q33: Under current market practice, which kinds of financial instrument are held in custody (according to current interpretations of this notion) in the various Member States?

Current market practice acknowledges that securities are intangible property, and custody agreements reflect the legal and operational realities of how dematerialised book-entry “securities” are “held” by custodians. Under current market practice, custodians agree to establish and maintain “securities accounts”, and “securities” are broadly defined as in our proposal above. So, under current market practice, what is viewed as being “held in custody” is widely interpreted and there is no narrowing of the interpretation as put forward in Options 1 and 2.

Box 79

We favour Option 3. However, it should be noted that by defining “collateral” by reference to the Financial Collateral Directive, some forms of financial collateral arrangements may not be caught. For instance, as a matter of English law, some collateral arrangements are not “financial collateral arrangements” within the meaning of the FCD. Also there may be issues with some forms of cross-border collateral. This is a complex area and more analysis is required.

We would also note that the FCD will need amending in order to fit with any references to / from the AIFMD.

Paragraph 29 page 157 provides that financial instruments provided as collateral under a “title transfer collateral arrangement” (TTCA) are to be classed as “other assets”. If this refers to collateral received by the AIF then we agree with ESMA. However, this should not be restricted to collateral received under TTCA as defined under FCD - or indeed “financial collateral arrangements” as defined under the FCD.

Instead, we are of the view that any financial instruments received by a depositary or sub-custodian as collateral (whether within the scope of FCD or not) for or on behalf of the AIF should be regarded as having been “entrusted to the depositary for safe-keeping” within the meaning of Article 21(8).

Finally, we believe that all collateral arrangements (not just FCD ‘arrangements’ should be subject to the depositary’s general oversight responsibilities as regards the adequacy of those arrangements put in place by the AIFM. This oversight duty might involve reviewing the selection, appointment and on-going use of the counterparty by the AIFM, the level of the haircut and the enforceability of the agreements (particularly relevant in the conflicts of laws situation where the counterparty is not located in a Member State for FCD purposes).

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

In practice, there should be no issue in differentiating between a TTCA and a “security financial collateral arrangement” as defined in the FCD. This would be done by reference to the agreement setting out the collateral arrangement.

Box 80

We agree with the general principles set out in this Box.

We agree with the requirement at paragraph 1(c) that the depositary should assess “all relevant custody risks”, however, we are puzzled as to why “the custody risks related to settlement systems” should be particularised. A settlement system normally deals with the “delivery” of securities against payment and thus it is the safekeeping of the securities and not the settlement of securities that should be the focus of the custody risk assessment referred to in the Box. It should also be clarified that any assessment relates to the central securities depositary as well as to settlement systems.

The disclosure requirement - which we view as key - should relate to the entire assessment and monitoring process and not just to “the custody risks related to settlement systems”. It should also apply to the entire custody chain, which issue is partially addressed in paragraph 2 of Box 80. This is in practice a key point as custody chains are prevalent if not the norm.

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

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?

The depositary has control in relation to (ii) and (iii) but not necessarily in relation to (i).

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

We think this would be desirable.

Box 81

Some assets falling into the category “other assets” are not tangible assets with ownership rights but rather intangible assets such as contractual rights as in the case of derivatives. We therefore wonder how an “ownership verification” obligation applies to such assets and would ask ESMA to clarify.

We believe that of the options raised in Box 81, Option 1 should be the preferred approach, as it places an oversight duty on the Depositary to ensure that proper procedures and controls are in existence.

Option 2 seems excessive, as it would require the Depositary to mirror the recordkeeping of all transactions. This would unnecessarily increase costs to AIFs, and therefore investors, without any additional benefit, and potentially lead to greater inefficiencies in the management of the assets by the AIFM.

It is important for the status of cash to be properly analysed and resolved. Cash broadly falls into two categories. The simpler scenario is that cash can be placed as a result of an investment decision by the AIFM with a third party. In that case, the AIFM is responsible for selection of the third party and should adhere to certain operational standards, which ought to be those set out in Article 16(1) (e) and 16(3) of MiFID level 2, together with the provisions of Article 18 of MiFID Level 2 (excluding money markets funds). The depositary should have an oversight responsibility over the actions of the AIFM.

The second scenario relates to “un-invested cash” (idle cash), which may be placed with the depositary or, if they do not have the relevant licences or operational capability, the depositary may take the decision to place the cash with a third party, be it a global custodian bank or another third party. In the former case, the general record keeping requirements of Article 16 apply to the depositary; in the latter case, the requirements of Box 89 apply responsibilities (set out above as applied to the AIFM) directly to the depositary.

Q38: What would be the estimated costs related to the implementation of option 1 or option 2 of Box 8? Please provide an estimate of the costs and benefits related to the requirement for the depositary to mirror all transactions in a position keeping re-cord?

We do not have specific cost estimates but would support Option 1. The depositaries are best placed to provide the answer to question 38. However, we believe that the requirements of Option 2 will give rise to additional costs as a result of the mirroring of the records of all transactions, which could be substantial (and dependent very much on the level of investment in systems and people required to maintain these records), without providing any real enhanced investor protection benefits. Option 1 should be sufficient to provide investors with the comfort that they require regarding the safekeeping of assets.

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

We agree that there needs to be look through to the underlying assets of a SPV.

Q40: To what extent do you expect the advice on oversight will impact the C78 depositary's relationship with funds, managers and their service providers? Is there a need for additional clarity in that regard?

Although we believe that the proposals with regard to the depositary's oversight duties are sensible, we have some concerns as to how this will be implemented in practice because some of these duties will be new to AIFs. It is unclear to whom the depositary would escalate matters as described in the third paragraph in Box 82 and the consequences of such action. An overbearing approach may lead to negative impacts on the depositary's relationship with portfolio managers and other service providers, but this is something that should be sorted out between the parties themselves rather than through further clarification by ESMA. For certain businesses, this type of relationship with the depositary is not new, but for AIFMs who have not had such a relationship with a depositary before they might find it more onerous to deal with.

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

Yes, hence the need for functional and hierarchical segregation of functions.

Q42: As regards the requirement for the depositary to ensure the sale, issue, repurchase, redemption and cancellation of shares or units of the AIF is compliant with the applicable national law and the AIF rules and / or instruments

of incorporation, what is the current practice with respect to the reconciliation of subscription orders with subscription proceeds?

Currently, for those AIF with depositaries, this function is usually performed by the administrator of the fund, which will make these available to the depositary for review. Other AIF do not currently have depositaries and the AIFM undertakes this function, which is subject to independent audit as part of the process of drawing up the annual accounts.

We therefore support ESMA's view that depositary oversight in respect of sales or units or shares should only apply where the AIF or AIFM is involved and would recommend that the guidance makes clear that oversight is not be required for transactions on secondary markets for the reasons set out in the consultation paper.

The need for the clarification recommended above highlights the fact that the precise obligations of the depositary will vary according to the legal structure of the AIFM it is employed by. For closed-ended AIF, such as UK investment trusts, it will rarely be a relevant consideration. We would therefore recommend that the guidance on the depositary's oversight duties states explicitly that the precise details of the depositary's role will depend on the nature, scale and complexity of the AIFM and the AIF it manages.

Box 82

The depositary should not be required to assess the risks associated with the AIFM. This goes further than the requirements of the level 1 text. It also undermines the AIFM's own fiduciary and regulatory duties as it is the AIFM (not the depositary) which is responsible for establishing its procedures and ensuring compliance with the directive. Any obligation of this nature risks significantly increasing the scope of the depositary's liability and would increase its exposure to risk and the cost it would charge clients.

We would also suggest that the depositary's role in overseeing third parties (in paragraph 2) is limited to considering the appointment process for those entities performing significant regulatory functions. The level 2 text should recognise the AIFM's own responsibility for monitoring the processes of third parties. The depositary should not be placed in a position where it has to either second guess or duplicate work which is properly the regulatory responsibility of the AIFM.

Q43: Regarding the requirement set out in Q2 of Box 83 corresponding to Article 21 (9) (a) and the assumption that the requirement may extend beyond the sales of units or shares by the AIF or the AIFM, how could industry practitioners meet that obligation?

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

In this context, we note that Paragraph 56 of the Explanatory Note for Box 83 states that the depositary should be responsible for monitoring distribution of shares in an AIF. Investment company shares are traded on secondary markets, where transactions are undertaken between shareholders without the participation of the AIF or AIFM. We would therefore recommend that the guidance should make clear that the depositary does not have any obligations in respect of share transactions unless the AIF and/or the AIFM are directly involved. Otherwise the impact of this could be very

costly, given pan-European distribution networks. We therefore believe this should be subject to a full cost benefit analysis.

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

We have concerns that the provisions set out in box 85 risk extending the depositary's role into areas which are more properly the duty of the AIFM. While the AIFM itself should be responsible for on-going monitoring of its investment restrictions and leverage, there is the risk that the current draft of the guidance might draw the depositary into on-going risk monitoring - as acknowledged in paragraph 61 of the Explanatory Note.

There should be no suggestion in the final guidance that the depositary has a role as part of the investment process *ex ante* and its role should be strictly limited to checks after the transaction.

We note similar concerns in the requirement for oversight of leverage limits. There should be no question that obligations in this area should be *ex ante*.

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 the Level 1 requirements are sufficiently clear.

Box 87

We would suggest it is for the AIFM (not the depositary) to respond to issues raised by the auditors. The depositary should have no obligations in this area and we would therefore recommend that paragraph 2 of Box 87 is deleted.

Box 88

We generally agree with the draft advice in Box 88.

Box 89 (and Box 91)

We perceive this is an important Box in ESMA's guidance when read in conjunction with Box 91 which we believe it should qualify.

As alluded to in our comments on Box 80 the practice of delegating custody - and the attendant creation of custody chains – injects a level of complexity into the safekeeping of assets for all funds and their management companies. This is a common practice and a typical chain might run from depositary to global custodian to local sub-custodian (securities depositary) although many are much longer – especially when emerging market assets are held.

It is therefore correct to impose these requirements on a *mutatis mutandis* basis as ESMA has proposed at paragraph 3 of Box 89, so that these provisions apply *mutatis mutandis* to the relevant parties in the chain to the extent that it is not the depositary's obligation to ensure segregation beyond its immediate delegate.

We would accept this position if it were clarified in Box 80 under paragraph 1(b) that “due care” would involve the depositary - as lead custodian to whom assets are entrusted for safekeeping – undertaking three key oversight duties. The ‘lead custodian’ would be obliged:

- To know which sub-custodians constitute the custody chain;
- To understand the relevant risks that exist at each level of the chain;
- To ensure that the due diligence and segregation obligations have been imposed throughout the chain (from delegate to delegate) at a contractual level; and
- To document all of the above and make these documents available – or even to occasionally report – to the appointing AIFM

The end result of such ‘lead custodian’ duties would not only be that the depositary can take comfort that the level of protection relating to AIF assets remains undiluted by subsequent delegations, but that the depositary can prove this comfort to its appointing AIFM via documentation - and thus effectively pass the comfort on.

We have no issue with the use of “omnibus client” accounts except where the use of such accounts impacts the level of protection for AIF investors.

Paragraph 2 of Box 89 in relation to the effectiveness of insolvency ring-fencing is a key point. The missing element in Box 89 is disclosure to the AIF and the AIFM.

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

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

It is for the depositaries and custodians to answer the first question, and we suggest it is for the legislators and the prudential regulators to answer the second question.

However, a back-of-the-envelope calculation would suggest that the implications of increasing costs should not be underestimated. The original proposal for a Directive estimated that €2 trillion is managed by AIFM employing a variety of investment techniques. Even a one basis point increase in costs because of increased liability risks implies an additional annual cost of €200m. It seems likely that the liability regime for AIFM depositaries will also have implications for the UCITS market meaning that the potential drag on investor returns would be even greater.

Clearly, this increases the importance of developing a proportionate solution which delivers outcomes which will really benefit consumers.

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

A typology is neither required nor desirable if the definition in Box 90 is retained.

Box 90

As drafted, the restitution obligation is only ever triggered if the assets in question are permanently unavailable. We believe this is too narrow and we suggest that the definition of “loss” in paragraph 1(c) be amended to read as:

“the AIF is unable to directly or indirectly dispose of the financial instruments having regard to the reasonable expectation of investors in the AIF”

We are also of the view that in the case of the insolvency of an affiliated sub-custodian (in the widest sense of the term, i.e. affiliate should be defined as any entity controlled, directly or indirectly by the depositary, any entity that controls, directly or indirectly, the depositary or an entity directly or indirectly under the common control with depositary), financial instruments should be considered “lost” upon the opening of the insolvency proceedings in relation to such sub-custodian.

As regards determination of loss in the case of sub-custodian insolvency and the monitoring of insolvency proceeding, whilst it is important for the AIFM to be involved in the decision as to when financial instruments entrusted to a sub-custodian are effectively lost, we do not believe that it should be the sole responsibility of the AIFM to monitor such proceedings. Rather we believe that it is the duty of the Depositary to monitor the proceedings and keep the AIFM informed so that the AIFM, in consultation with the Depositary, can decide when an asset is lost. The penultimate paragraph in Box 90 should be amended to reflect this.

Box 91 (and Box 89)

From an investor perspective we believe it would be reasonable for the depositary to be exonerated from liability provided it can prove that it fulfilled the due diligence and segregation requirements as set down in AIFMD Level 1 and as we have proposed for the draft ESMA advice - particularly with regard to the custody chain and our comments on Box 89 in the context of which these comments should be read.

The three definitions of “financial instrument”, “loss” and “external event” need to be considered together to define the liability profile. So, subject to our position on “financial instruments” and “loss” (including as to timing trigger for an insolvent affiliate) being accepted, we would argue that Paragraph 1 of Box 91 should be restricted to cover the acts and omissions of the depositary and of sub-custodians who are affiliates of the depositary (in the widest sense of the term affiliate) so that only such events are “internal”. As currently drafted any event occurring in the custody network at an affiliate or non-affiliate sub-custodian is “internal” so the depositary is liable for “financial instruments” (as currently defined) which are “lost” (as defined).

Paragraphs 2 and 3 of Box 91 are confusing and potentially conflicting. In particular, paragraph 3 (a) - (c) risks placing the depositary in a situation where it is required to second-guess the investment expertise of the AIFM. It requires the depositary to identify ‘external events’ which may present a significant risk of loss of the instrument. This could require a depositary to, say, take a view on the political situation a particular market where it has no experience. On the other hand, the AIFM is already required to have investment expertise in such markets (this is a condition for it being the AIFM, see Article 8. 1. c of the level 1 text). The AIFM’s investment strategy may require exposure to markets where risks of loss of assets are part and parcel of the investment proposition. The depositary should not be put in a position where it should seek to second-guess or direct the activity of the AIFM. The depositary should not be required to try and eliminate risks of this nature and we would recommend that paragraph 3 of Box 91 be clarified.

Q49: Do you see any difficulty with the suggestion to consider as an external event the fact that local legislation may not recognise the effects of the segregation requirements imposed by the AIFMD?

We see no difficulty. It is a reasonable position and indeed this is in line with investor expectation.

The local law restrictions on the recognition of segregation is a form of custody risk. However, it is our view that it is a risk that properly falls to the AIF and its investors provided certain conditions are met, namely that there is proper disclosure to the AIF and the AIFM of such risks and that all the operational standards applicable to depositaries are met, ie. the due diligence requirements and ongoing monitoring requirements.

If the investor were to invest directly in the relevant jurisdiction, it would be exposed to this same risk. Investors do not expect or want depositaries to underwrite this particular custody risk (subject to the conditions mentioned above).

Q50: Are there any events which should specifically be defined /presumed as 'externals'?

Subject to our position on “financial instruments” and “loss” being accepted, we would advocate that the acts, omissions and insolvency of a non-affiliated sub-custodian should be defined as an “external” event. The acts, omissions and insolvency of a securities depositary or settlement system should also be defined as an “external” event.

Any events which would be classified as pertaining to country risk, political risk and/or market risk should be regarded as “external” events. These are investment risks, which the investors willingly assume and factor into their understanding of the risk /reward equation.

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

The depositary should be liable for the acts, omissions, fraud and insolvency of an affiliate sub-custodian (widely defined as any entity controlled, directly or indirectly by the depositary, any entity that controls, directly or indirectly, the depositary or an entity directly or indirectly under the common control with depositary).

We are of the view that any such events resulting in loss would be “internal” events. In particular, if an affiliate sub-custodian that holds AIF assets becomes the subject of insolvency proceedings, the depositary should be liable to return equivalent assets to the AIF upon the onset of insolvency.

Box 92

Option 1 is the preferred approach as it provides clarity as to the circumstances in which the depositary might contractually discharge itself from liability from the outset.

Option 2 is too open-ended and it is hard to envisage circumstances in which an AIF or AIFM, acting in the interests of the investors of the AIF, would explicitly agree to discharge the depositary’s liability in circumstances other than those mentioned in Option 1.

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

This mechanism is legally complex and uncertain. It is not certain that depositaries would be willing on a commercial basis to enter into such arrangements with their clients.

From a legal perspective, further detailed analysis will be needed on a jurisdiction-by-jurisdiction and a case-by-case basis.

Leverage

We note that ESMA uses the terms “exposure” and leverage” interchangeably throughout this section which can be misleading.

We are concerned that the Directive places too much importance on Leverage, and in particular on Gross Leverage, as a useful statistic for Regulators and Investors. Gross Leverage does not measure, and is poorly correlated with, the Risk of a portfolio to the end-investor, or the systemic risk that a fund poses.

Leverage is only one of many measures of risk of a portfolio and so taken alone – or with undue significance placed upon it - can be misleading and dangerous. This same logic applies to any risk that is singled out or over-prioritised.

Given that Gross Leverage does not helpfully measure Volatility, Counterparty Risk or Liquidity Risk, we would suggest it is not a helpful headline measure of the riskiness of a fund – from either a systemic risk or investor risk perspective.

We suggest that Gross Leverage should be de-emphasised from the monitoring of AIF risks and a more nuanced approach, including VAR, volatility, drawdown, net counterparty risk, and liquidity measures be adopted. Unfortunately, we do not believe there is a helpful shortcut for a rounded understanding of the risks of an AIF.

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

Why? What amendments should be made?

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

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?

CDSs and Spread betting should be included in the list. The list as presented is confusing in that it refers to the broad category of contracts for differences as well as to total return swaps and interest rate swaps which are themselves simply types of CfD. We imagine the specific reference here to CfDs is intended to cover plain vanilla single stock equity CfDs and the like.

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

We would suggest that an alternative method, including offsetting, be created outside the Advanced Method framework in order to create an industry standard Net Exposure regime.

Otherwise, we agree with these basic principles in creating a methodology.

We agree that an advanced methodology should be applied consistently between AIFs where they are of the same type. However, it may be legitimate to have multiple advanced methodologies in place for a large AIFM covering multiple asset classes caught by the Directive (e.g., Index funds to Equity long-short to private equity).

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

We do not think any clarification is needed.

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 agree that cash and cash equivalents should be excluded from the Gross Method Calculation. We also suggest that conservatively managed AAA Money Market investment funds should receive the same treatment.

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

We have not reached a definite conclusion. Some of our members prefer Option 3 regarding it as clearest in identifying what should and should not be included and appears to grasp best both legal and economic form and substance that are relevant to identifying whether, on the one hand, the net assets or, on the other hand, the gross assets and liabilities should be taken into account.

Others believe Option 3 creates uncertainty. In particular, Limb 1 specifies that AIFMs shall not include in the calculation of leverage exposures any exposure contained within third party structures where the capital at risk is not greater than the market value of its holding in the relevant shares or units. Limb 2 states that leverage shall include exposures gained through guarantees and the giving of security in specified circumstances. It is unclear what would happen where there is exposure greater than the market value of the shares but it is not gained through guarantees or the giving of security in the specified circumstances. Also, it is unclear why the calculation of leverage exposure hinges on the market value of shares rather than amount paid for such shares.

We do think that Option 1 is preferable to Option 2 as it is more logically sound. Exposure on the basis of a guarantee is not dependent on whether or not the guaranteed company is listed or unlisted or whether it is controlled by the guarantor. Whether or not an exposure is realised is dependent on the terms of the guarantee, not these other factors. It is not, however, appropriate to count exposure guarantees that are not legally enforceable. The provision that “guarantees” in respect of which there is no legally enforceable obligation but “an expectation” are to be counted in the leverage calculation is ambiguous and should be deleted.

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?

The use of SPV should not be permitted to disguise leverage that investors are economically exposed to. If the SPV is a wholly owned subsidiary its assets and liabilities should be consolidated. If it is majority-owned its assets and liabilities should be proportionately consolidated if the economic exposure is to be correctly calculated.

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

Leverage alone is not a sound measure of the risk of an AIFM and it needs to be assessed in the context of the riskiness (volatility) of the assets and liabilities of the fund and the extent (if any) to which movements in the prices of these assets and liabilities might expect to correlate, either positively and negatively. This is a matter on which both objective measurements and judgment need to be brought to bear. We would suggest that an undue focus on Gross Leverage is unhelpful, given the imperfect and nuanced link between Gross Leverage and risk. Regulators should be encouraged to take a more effective approach. We would suggest that some combination of Net Leverage, realised volatility and exposure to certain assets or markets should be used to assess systemic risk.

Any decision by a competent authority seeking to impose restrictions on a fund for reasons of systemic stability must be soundly judged and substantiated.

Paragraph 5 of Box 100 is of particular importance in making clear the responsibilities of competent authorities as regards timing of any intervention which, in restricting the ability of the fund manager to take investment decisions could have a significant impact on the interests of the investors in the fund.

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

Many regulators already possess the powers defined in Box 100 (though not so clearly linked to leverage). It is critical that these powers are used only in extreme circumstances and with transparent and predictable criteria. We would suggest that a mandatory first step should be for the regulator to enter into dialogue with the AIFM.

We would suggest that the Competent Authority should present the evidence of its concerns to the Board of an AIF and demand a written response within a short timeframe. This would enable a greater understanding to be developed before an arbitrary leverage cap be imposed.

Forced deleveraging of an AIF will create material costs for investors (trading costs, and depressed asset prices); hence, the burden of proof should be set with this

balance in mind. Strict confidentiality would also be required. If a regulator became concerned about long leverage in a certain sector, a public pronouncement of a leverage limit and forced deleveraging would likely cause a price collapse. This forced selling at “fire sale” prices would have a material detrimental impact on investors.

We would suggest that communication with the AIFM could avoid circumstances in which Leverage Caps were imposed through misunderstanding of an investment strategy or the risk created by this investment strategy.

We would also draw attention to the Global context of AIFs. If a single national regulator becomes concerned at the price movement of an asset and imposed a leverage limit, then local funds would be forced to de-leverage, but funds in other Member States, and funds outside the remit of the AIFMD, would still be able to pursue their investment strategies. This would create a detrimental impact on the investors in the local AIF, while not achieving the aim of the concerned regulator.

The impact of Box 100 will be understood only through its application. The rights of investors to avoid unnecessary de-leveraging need to be considered as well as the overriding responsibility to the financial system.

Transparency requirements

We have one key concern about the transparency requirements. We consider the reporting requirements to competent authorities to be extremely onerous.

We strongly believe that rather than quarterly reporting, reporting should be on an annual basis, with competent authorities having the right to request more frequent reports if appropriate.

We also note that under Annex V, Sections 2 and 3 need to be completed only by AIFs “*which are material*” – although this is square bracketed as if its inclusion is still a matter for debate.

We think it critical that these sections need be completed only by AIFs of such a size or style as to pose systemic risk. There is no point in CAs being overloaded with information as they will not be able to assess and utilise this volume of information effectively, and it would cause disproportionate and unjustifiable regulatory costs for the industry and, therefore, investors.

We therefore request that ESMA define the meaning of ‘material’ either in terms of the size of an AIFM or the style of its investment.

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?

In general we support ESMA’s approach here, which appears to provide sufficient flexibility to accommodate the UK accounting framework.

One exception, though, is in Box 102 (2) where the wording could imply that the AIF is required to have accounting rules set out in its own rules or instruments of incorporation. This would not be a suitable requirement. Investment companies (and, we anticipate, many other AIFs) do not set out such rules but instead rely on relevant accounting standards. This should be acceptable for the purposes of the Directive.

Another is in Box 104 paragraph 7(a), where we are concerned that there is too much prescription in the sub-classification - in particular, with regard to the separate disclosure of realised and unrealised gains.

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?

Data Protection issues need to be considered, and exemptions made as appropriate. We consider that the remuneration disclosures should be subject to similar exemptions as are available to firms under CRD, which effectively allows information that is immaterial, confidential or proprietary not to be disclosed. The implementation of similar exemptions would ensure a level playing field across all firms subject to remuneration disclosures, which was one of the original objectives of the G20 when remuneration proposals were first tabled.

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

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

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?

We believe that Article 23(4) (b) should be read as referring to arrangements that are new to investors. If, for example, under the AIF's rules/prospectus, the tools for liquidity management are set out and the AIFM wishes to introduce a new tool, which may materially affect investors, the introduction of that new tool is captured by Article 23(4) (b). If, on the other hand, an AIFM is making use of an existing tool for the first time, then this scenario is not intended to be captured by this Article. The advice should be clarified so that it is clear that it relates to the introduction of new tools, not intended to capture the use, for the first time, of existing disclosed liquidity management tools.

As regards the last sentence of paragraph 4 of Box 107, we consider that the only event that should require immediate notification is that of fund suspension. The notification of other types of event should be governed by the notification requirements in the AIF's prospectus. If the AIF prospectus is silent, disclosure should be in line with the AIF's periodic reporting to investors as required by the AIF's rules or instrument of incorporation, prospectus and offering documents and, at a minimum, in the annual report of the AIF.

In addition, for the reasons given above, the activation of a gate, in cases where this right has been disclosed, is not a new arrangement but use of an existing one. Disclosure each time such an existing tool is used could potentially damage an AIF as it may cause investors to panic upon receipt of the notice and sell where otherwise they would not. Use of existing liquidity management tools that investors are aware of and on which basis they have purchased units in the AIF should not be considered as matters requiring special notification, unlike the introduction of a right to use a new tool.

The text of paragraphs 10 and 11 of the Explanatory Text should also be amended in the light of the above comments on Box 107.

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

See our comments above on liquidity.

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

We strongly prefer Option 1. Option 2 is significantly more demanding and less flexible than Option 1; in particular, the result of stress tests is not normally the type of information that would be disclosed in annual reports.

As Option 1 offers more discretion in making the disclosure we also think it should result in higher quality information being provided to shareholders. This approach will secure a better regulatory outcome.

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

No, this should be at the discretion of the AIFM in order to ensure it both appropriate and proportionate.

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

We consider that for periodic reporting to prescribe this on a quarterly basis seems excessive. This will not provide enough elapse of time for the user, in this case the competent authority, to take a fresh perspective on the entity. Also, the Competent Authority has the power to require additional reporting where appropriate – e.g. under times of market stress.

We agree with the suggestion that the provision of information be aligned with the accounting reference date for the financial statements and, as such, question the statement that “*it is anticipated that information would be provided as at 31 December, 31 March, 30 June and 30 September*” which would seem to detract from this requirement.

We believe that an annual report may be sufficient (though perhaps there is a case for semi-annual in line with numerical reporting requirements for equities admitted to trading on a regulated market) but with a requirement to report material changes in the interim.

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 do not have any estimates to provide, but in general we are concerned about the

volume of information and the potential costs, particularly if this information is required quarterly. However we note from Annex V that only section 1 is applicable to all AIFMs; Sections 2 and 3 apply only to an AIF “which is of a material size”. Much will depend therefore on which AIFs fall in this category and we would ask that ESMA provide clarity at as early an opportunity as possible.

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 suggest that a one month turn around for such information is too tight and does not accord with timeframes applicable, for example, for annual reporting by companies admitted to trading on regulated markets, and the desirability of aligning reporting with normal audit processes.

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?

There is a risk that, with an eye to anticipated views of particular competent authorities, there will be insufficient harmonisation across Europe, thereby leading to inconsistent information that would impair comparability. Further guidance from ESMA might therefore be helpful.

The fact that there is considerable flexibility for the AIFM to make the assessment as to when leverage is being employed on a substantial basis is potentially problematic, as they will need to do so on a consistent basis across all the funds they are responsible for. There is a risk that, with an eye to anticipated views of particular competent authorities, there will be insufficient harmonisation across Europe, thereby leading to inconsistent information that would impair comparability.

Given that the Competent Authority has the power to impose restrictions in such a case, clearly the AIFM will be reluctant to make such a notification. On the other hand, we appreciate that an overly mechanistic approach (e.g. specific percentages) is inappropriate given the diversity of different types of AIF.

One approach might be for ESMA guidance to establish a minimum level where leverage cannot be deemed substantial.

Further guidance from ESMA would therefore be helpful.

13/9/11