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European Securities & Markets Authority
103 Rue de Grenelle
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Dear Sirs

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

By way of background, Baillie Gifford & Co is an independent investment management firm based in Edinburgh. We manage about £72bn, almost wholly on behalf of institutional clients, and employ about 670 staff. The firm is a private partnership established under the laws of Scotland and includes a group of companies which are authorised and regulated by the FSA.

Baillie Gifford will be impacted by the Directive as it is the investment manager for 8 UK domiciled investment trusts, a UK 'Non-UCITS Retail Scheme' and an Irish 'Qualified Investor Fund.'

Investment trusts are closed-ended collective investment vehicles whose shares are traded on public markets. They are overseen by a board of directors and offer their shareholders access to a diversified portfolio of assets. They are already regulated by the UK Listing Regime, UK and European Company Law, and European Prospectus and Transparency Directives.

Non-UCITS Retail Schemes are open-ended collective investment schemes, authorised by the UK Financial Services Authority and are capable of being promoted to retail investors in the UK. They are required to operate within the parameters of the FSA's Collective Investment Schemes Sourcebook (COLL).

Qualified Investor Schemes are open-ended collective investment schemes, regulated by the Central Bank of Ireland and required to comply with Non UCITS Notice NU 24.

All of the above funds would be considered 'long only equity or fixed income funds.'

We welcome the opportunity to engage in the consultation process around the implementing measures of the Alternative Investment Fund Manager Directive. We have had the opportunity to review the responses of our trade bodies, the Investment Management Association and the Association of Investment Companies and endorse their views. We additionally wish to provide responses to the questions posed which are provided overleaf.

If you have any questions regarding the content of our submission, please do not hesitate to contact me.

Yours faithfully

A handwritten signature in black ink, appearing to read "Kath Moses".

Katherine Moses
Regulatory Developments Manager

Responses to questions raised by the consultation

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.

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. AIFMs should be able to use the date most appropriate to them. The value of the assets will usually be the subject of an annual, external audit report and this will generally be the preferred date for AIFMs. Moreover, if a single date is prescribed, this would 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.

Yes, the annual net asset value calculation is appropriate for the AIFs for which we act as investment manager.

Q4: Can you provide examples of situations identified by the AIFM in monitoring the total value of assets under management which would necessitate a re-calculation of the threshold?

The implication of requiring an annual net asset value calculation is that there should not be an obligation to maintain a 'running' NAV calculation. Instead the requirement should be for an additional NAV calculation if an event might reasonably be considered likely to increase the assets under management to the extent that the threshold is breached. Relevant events would be:

- the adoption of gearing by a previously un-gearred AIF;
- the acquisition of a new AIF contract or launch of a new AIF by an AIFM;
- the merger of an AIF with an AIF not currently managed by the AIFM;
- an issue, or sequence of issues, of new shares by an AIF which raises capital which, when added to the previous NAV used for assessment against the threshold, would breach the threshold.

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

No. If a fund is exempt then it should not be included in the AIFM's AUM.

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?

No. The approach should 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.

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?

For Box 2, see our comments under Question 6 above.

We have the following comments on Box 1, paragraph 5:

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 number of notifications which are unnecessary. Additionally, 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. Our members have suggested up to 12 months.

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 scope of coverage proposed is problematic as it could require risks to be covered which are the responsibility of third-parties. Where a problem arises with a supplier performing delegated functions then that supplier will have its own insurance and the AIFM will be able to take action against it for any professional negligence. There should be no requirement for an AIFM to overlay its own insurance with that already taken out by its service providers. This would significantly increase costs for no regulatory value and without delivering additional investor protection.

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. There is no correlation between performance fees and risk levels, so this should be excluded.

Also, with reference to Box 8, in terms of a self-managed AIF, the only income received is from investments, which is distributed to shareholders, the AIFM (which is the AIF) does not receive income in relation to collective portfolio management activities.

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’)?

Yes, this is practicable.

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 numbers, please provide evidence for this suggestion.

We have a preference for option 2, as self managed funds will not have relevant income, this lowers the costs associated with running the AIF and therefore the costs to be borne by investors.

Q13: Do you see practical need to allow for the ‘Advance Measurement Approach’ outlined in Directive 2006/48/EC as an optional framework for the AIFM.

No, 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 Directive 2006/48/EC. Within the AIFMD, there is no specific obligation placed on an AIFM to manage operational risk. It therefore seems unnecessary to include reference to the standards required of firms (banks) which have a legislative obligation to measure, manage and mitigate operational risk.

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?

We fully support the lower requirement where AIFMs are able to demonstrate that the risk to which they would be exposed by holding lower levels of additional own funds would not result in a material increase in the risk presented by that AIFM.

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 AIF with fewer than 30 investors)? Where there are more than 30 investors, the amount in paragraph 3 (b)

would be increased e.g. to €3.5 m, while for more than 100 investors, the amount in paragraph 3 (b) would be increased e.g. to €4 m.

No. We do not see a link between the number of investors in the AIF and the potential liability risks arising from professional negligence.

It is common for AIFMs to outsource services, such as investment management, and in these circumstances, the outsourcee would itself have either PII or own funds to cover the risks posed to activities for which it is responsible. In this case, reliance should be placed on the outsourcee's PII. It is not reasonable to require the AIFM to also have PII for the same activities leading to duplication of insurance and unnecessary cost for investors.

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?

Overall, we have no difficulty with the requirements in paragraph 4 of Box 1, provided that they are applied only where appropriate (i.e. in relation to real estate and private equity vehicles). Paragraph 11 of the Explanatory Text makes it clear that this should apply only to real estate and private equity vehicles – this should be explicitly stated at the beginning of paragraph 4 of Box 11.

We would also query the use of the term 'business plan' which we think is misleading. The term 'investment proposals' might be more appropriate.

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

We have a strong preference for Option 1. The concept of overall material disadvantage is vague and subjective. The Level 1 requirements are sufficient here and there should be no further detail at Level 2.

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

No additional safeguards are required. ESMA's advice is very prescriptive and might prove very difficult for smaller firms and constitute a barrier to entry.

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?

In our view, small self-managed investment trusts may have difficulty in demonstrating that they have an independent risk management function.

Q 20: It has been suggested that special arrangements such as gates and side pockets should be considered only in exceptional circumstances where the liquidity management process has failed. Do you agree with this hypothesis or do you believe that these may form part of normal liquidity management in relation to some AIFs?

We do not utilise 'gates' or 'side pockets' and therefore have no view on this issue.

Q 21: 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?

Due to the closed ended nature of investment trusts, we have no comment on this issue.

Q 22: Do you agree with ESMA's proposed advice in relation to the alignment of investment strategy, liquidity profile and redemption policy?

Box 32 recognises that the obligations applying to leveraged closed-ended AIF should differ from those relevant for other funds. This is welcome but 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. We therefore recommend that part 1 of box 33 be adjusted so that paragraph (e) is included in the provisions which leveraged closed-ended funds need not comply with.

Q 23: 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.

Q 24: Do you prefer Option 1 or Option 2 in Box 65? Please provide reasons for your view.

We prefer Option 1. Option 2 risks limiting the reasons that could be cited to justify delegation.

Duties of the Depositary

We have had the opportunity to review the responses of our trade body, the Investment Management Association to section V and endorse their views.

Q55: ESMA has set out a list of methods by which an AIF may increase its exposure. Are there any additional methods which should be included?

We recommend that CDS is added. We also wonder why TRS and IRS are listed separately when they are CFDs?

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 this 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.

ESMA appears to have rejected the use of VaR, citing the exposure of the VaR method to the breakdown of correlations in stressed market conditions. But the Commitment method is so complex that a fully automated implementation is impossible. In particular, it requires daily calculation, which implies an automated monitoring process, but includes decision points in the calculation requiring complex judgements to be made, which cannot be programmed. In addition, the duration netting process requires optimisation calculations not offered by the best commercial monitoring platforms. This would produce an inefficient hybrid process, part automated and part human intervention. Daily VAR, by taking into account all positions, represents an escape route from this computational impasse. There also appears to be no provision for ceasing to calculate the Commitment Method when adopting the Advanced Method.

An example where VaR would be preferable would be in relation to fixed income portfolio construction and the use of contributions to duration rather than portfolio weights in considering exposures to certain trades. An example of this would be when using swaps to gain a 1-year long exposure in a given country: using a swap with a fixed leg that has a short duration means that a larger portfolio weight in each of the swap legs will be required to gain this level of duration exposure, compared to using a swap which has a longer-duration fixed leg. Using the Gross or Commitment Approach methods, leverage/exposure will appear higher using the shorter-duration instruments, even though the two positions have the same sensitivity to the underlying interest rate.

Furthermore, swap positions of meaningful duration exposure using short duration instruments will be much larger in portfolio weight than similar duration exposures obtained through the use of longer duration instruments. Whilst the duration exposures (first-order sensitivities of these positions to changes in interest rates) of these two positions will be identical, the position expressed using shorter duration instruments will be penalised in terms of the Gross/Commitment approaches to exposure due to the higher portfolio weights in each of the swap legs. VaR is a risk model approach that, whilst using the portfolio weights of the instruments, will be sensitive to the durations of those instruments and is likely to provide a more realistic interpretation of 'exposure'.

For the above reasons we would recommend that the reporting requirements of regulators charged with maintaining market stability should not determine the risk control methods

permitted for asset managers, and in particular that VaR be a permitted advanced monitoring method where appropriate for the particular AIF.

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

No further clarification required.

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.

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

Option 1 is preferable.

Q60: Notwithstanding the wording of recital 78 of the Directive, do you consider that leverage at the level of a third party financial or legal structure controlled by the AIF should always be included in the calculation of the leverage of the AIF?

We have no view on this point as it is not relevant to our business.

Q.61 Do you agree with ESMA's advice on the circumstances and criteria to guide competent authorities in undertaking an assessment of the extent to which they should impose limits to the leverage that an 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 is not a risk measure and therefore, any intervention must be based on sound analysis and evidence of systemic risk. An option to consider is the level of leverage given the risk profile of the fund and the level of volatility.

We strongly support paragraph 5 of Box 100 as timing is an important fact in protecting investors from market instability caused by competent authority intervention.

Q 62: 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?

It is essential that regulators carefully consider the impact of any restrictions they may impose on leverage, weighing the systemic benefits against potential damage to investors.

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?

The general approach allows AIFMs to report against relevant accounting standards according to their domicile. This is an appropriate approach which we support. We recommend that ESMA ensure that any level 2 guidance on disclosures in the annual report should not conflict with obligations to make required disclosures in accordance with the Transparency Directive.

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?

We consider that the remuneration disclosures should be subject to similar exemptions as are available to firms under Directive 2006/48/EC, which effectively allows information that is immaterial, confidential or proprietary not to be disclosed. The implementation of similar exemptions would ensure a level playing field across all firms subject to remuneration disclosures, which was one of the original objectives of the G20 when remuneration proposals were first tabled.

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, that 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.

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

We have no comments on this question.

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

We have a strong preference for option 1. It offers more discretion in making the disclosure and 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 how the risk management system should be disclosed to investors? If yes, please provide suggestions.

No.

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

No. Quarterly disclosure is too frequent. It is difficult to see what use the competent authorities will make of these disclosures. We recommend that, in normal market conditions, annual disclosure is sufficient. In times of market stress, or other exceptional circumstances, the competent authority would be able to require more frequent reporting from all – or some - AIFM. An AIFM might also be required to make a disclosure if its investment exposure changed materially between annual reports.

Q70: What costs do you expect completion of the reporting template to incur, both initially and on an on-going basis? Please provide a detailed analysis of cost and other implications for different sizes and types of fund.

The reporting template is too detailed if quarterly reporting is to be required (although may be suitable for annual disclosure). It will be onerous to complete and submit and is likely to utilise significant administrative resources. It is also unclear how this information would be used if secured on a quarterly basis. We have no specific figures, its estimate is that the benefit will not outweigh the cost.

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?

No one month is too short. Assuming this is done annually, we believe that this should be aligned to the reporting deadline for the annual report.

Q72: Does ESMA's proposed advice in relation to the assessment of whether leverage is employed on a substantial basis provide sufficient clarity of AIFMs to enable them to prepare such an assessment?

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. Given that the CA 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.