

Reply by the VGF (Verband Geschlossene Fonds e.V.¹) to CESR's "Call for Evidence on Implementing measures on the Alternative Investment Funds Managers Directive"

VGF would like to express its thanks for the opportunity to comment under the "Call for Evidence on Implementing measures on the Alternative Investment Funds Managers Directive".² German non-tradeable closed-end funds (NTCEF) have thus far remained outside the scope of European capital market regulations. Under German capital market supervisory law there is a provision regarding the drafting and approval of sales prospectuses. There are also industry standards such as the obligation to compile track records (annually published records of all results of all funds under management) and membership of the NTCEF ombudsman. Adherence to these standards is an essential prerequisite of membership of the VGF. The AIFM Directive will, therefore, be the first European regulatory regime to apply to German NTCEFs. The requirements of the Directive pose a major challenge for the players in this market, who will have to adjust to a new operating context. We are pleased to submit our proposals and comments, which we hope may pave the way to practical, effective, economically feasible solutions.

We shall start by answering the questions listed in the Call. Please also note our additional remarks on the questions raised by the European Commission with regard to Level 2 measures.

Question 1:

Which categories of investment manager and investment fund will fall within the scope of the Alternative Investment Funds Managers Directive in your jurisdiction? Please provide a brief description of the main characteristics of these entities (investment strategies pursued, underlying assets, use of leverage, redemption policy etc).

Besides managers of other German fund categories such as, for example, open-ended real estate funds, special funds and private equity funds, the AIFM

¹ The VGF (Verband Geschlossene Fonds – Association of Non-Tradeable Closed-End Funds) is the interest group representing suppliers of non-tradeable closed-end funds (NTCEF) in Germany. Through its 54 members, the association represents some EUR 134 billion (portfolio of assets under management), managed in about 2200 funds. Related to the total market in Germany with a fund volume of some EUR 164 billion, the association therefore represents about 80 % of the CEF market. Further information is available at: www.vgf-online.de. The abbreviation VGF will be used in the following.

² All further references to the AIFMD refer to the text agreed in the trilogue on 26 October 2010 ([Council document: 15053/1/10](#)).

Directive will include managers of German NTCEFs. Representing the interests of suppliers of NTCEFs, we shall now take a closer look at these funds and their managers.

Suppliers of German NTCEFs tend to be small and medium-sized companies. In 2009, each issuing house managed an average EUR 1.754 billion worth of assets.³ This illustrates that suppliers of NTCEFs are of relatively small size compared to suppliers of other capital market products e.g. open-ended funds. In that respect, rules should be structured proportionally.

German NTCEFs also differ fundamentally from closed-end funds operated in other member states. Specifically, closed-end funds in the English-speaking world are quite different to German NTCEFs in terms of their conception and the legislation they are subject to. German NTCEFs, for example, are not listed, and their shares are not traded on stock exchanges. Hence the implementing measures of the AIFM Directive should bear in mind the following aspects:

Equity structure: German NTCEFs are partnerships in which the capital provided by several investors is pooled to invest in assets which individual investors could not finance by themselves. This allows retail investors, with comparatively small sums, to participate in major investment projects such as an office building, or a container ship; such projects would otherwise attract institutional investors only. In 2009, the total fund volume amounted to some EUR 21 million on average; the average investment was EUR 30,000. By investing in a NTCEF, the investor becomes a partner. For tax purposes, he or she is a co-entrepreneur. The goal is to share in the economic success of the project, e.g. in the rental income from real estate. The entrepreneurial character of NTCEFs does mean, however, that the investor also exposes himself to the associated economic risks. The entrepreneurial rights and obligations of investors are often handled by a trustee. The latter is, however, strictly bound by instructions. He is entrusted with the cash flows and represents the investors at the General Meeting. The fund's structure is vested with legal capacity, and the fund may participate in business on an independent basis. It must have a management board which reports directly to the shareholders and is appointed with clearly defined authority as stipulated by the law and the partnership agreement. The highest decision-making body is the General Meeting.

Investor structure: The investor structure of NTCEFs is not always uniform. Most NTCEFs are sold to retail investors, but there are also special products designed exclusively for institutional investors. Finally, there are NTCEFs involving both retail and institutional investors.

Founding and duration of the fund: NTCEFs are typically associated with a specific project or asset: to build or acquire a specific investment object (e.g. real

³ The median value is EUR 360 billion assets under management per issuing house.

estate, ship, aircraft), an investment company is set up. The investment required to finance the object is raised through investment capital, frequently topped up with loans. In most cases, the required fund equity is provisionally financed by the investment company via a short-term bank loan until the necessary investor capital is found. The fund is closed at that point, or immediately after expiry of the pre-defined investment deadline, but no later. From this point on, no further investors are accepted. This limits both the investment volume and the number of investors. Once the fund is closed, the asset is managed for an average of 15 years before it is sold and the fund is dissolved.

Rights of redemption and assignment: Issuers of fund units have no obligation to redeem shares for the duration of the fund. Holders may legally sell shares in NTCEFs during the duration of the fund, and this is often done via 'secondary market platforms'. Procedure requires a written contract of purchase and assignment, the agreement of the investment company and / or trustee, and, in many cases, entry in the Register of Trade. Given such strict requirements, there is comparatively little trading on the secondary NTCEF market; this limits fungibility.

Investment strategies: NTCEFs usually invest in assets which are defined in advance. No other assets are bought during the fund's lifetime. In 2009, 45% of funds were single-asset funds. 55% of funds invested in several assets, although not usually more than three assets. Generally speaking, the assets in multi-asset funds are closely related; investments may be made in different office buildings in the same commercial park, for example. Two types of structure are found in multi-asset funds: parallel investment in several investment companies (where funds are invested in ships or aircraft, the term 'fleet fund' may be used) and funds of funds. Funds of funds are not used to invest directly in one asset, but rather in one or more target funds. The target fund actually makes the investment in one or more specific assets (target objects). This object will not usually be sold during the lifetime of the fund. NTCEFs also include blind pools. The characteristic feature of such pools is that, instead of a pre-determined target object or target fund, only essential investment criteria are specified.

Duties of the suppliers: NTCEFs are designed and put together by legally independent suppliers, the issuing houses. They set up the investment company by drawing up a partnership agreement appropriate to the fund, they acquire the investment object and they ensure all the necessary contracts (e.g. partnership agreement, purchase/lease contract) are signed. Funds for offer on the open market must also be accompanied by a sales prospectus requiring the approval of the Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht – BaFin); the supplier is responsible for the content of the prospectus. The prospectus must provide potential investors with full and correct information about all key aspects of the investment prior to the acquisition of shares. A NTCEF is then usually sold to investors via commercial banks or independent investment brokers. Virtually all sales take place in

Germany; small sales structures are also present in Austria. In traditional NTCEFs, the investment volume is fixed prior to placement. Minimum investment sums apply to shares in the fund, usually between EUR 10,000 and EUR 25,000.

External financing: NTCEF investment objects are often financed with a percentage of external capital. Some two-thirds of the funds launched in 2008 and 2009 were underpinned with external capital. External capital usually makes up some 50% of the fund volume. It may be more or less, depending on the asset class, but it is very rare that the percentage of external capital exceeds 75%. There are also funds with no external capital at all. External capital usually takes the form of loans from credit institutions which are paid off during the lifetime of the fund. Their sole purpose is to provide the capital required to finance the fund asset. Low volumes of external capital are typical of NTCEFs; at around 50%, they have more in common with traditional financing structures. This conservative use of external capital should be borne in mind when defining leverage in more detail. NTCEFs generate their yields from the assets in which they invest, not by using financial-mathematical methods. High leverage ratios would mean higher bank margins; hence they would only make sense if one were counting on asset appreciation - but this is not a prime aspect of long-term asset management. Further, any increase or change in the use of external capital during the lifetime of a NTCEF must be formally approved by the General Meeting, i.e. by a majority of investors. A manager of a NTCEF cannot make sole decisions about the use of new external capital, or about changes to the scope of current external capital-related obligations, especially not when the volumes in question are large. In NTCEFs, this means that short-term speculative transactions based on external capital, i.e. transactions which could result in systemic adverse effects, are impossible from the outset.

Fund management: NTCEFs are managed by a variety of entities. The customary legal form adopted by NTCEFs - GmbH & Co. KG - gives each fund a shareholder who is legally appointed to the management: the general partner. Depending on the field of business, there will also be an executive limited partner who is invested with a managerial role under the partnership agreement. Both are usually connected with the issuing house. The general partner company usually has only modest financial and material resources. Further, operative management of the investment object is usually entrusted to a third party. Given the frequently modest financial and material resources of the management, key tasks beyond pure asset management, especially of a commercial nature, are usually executed by the issuing house. It is not clear thus far which of the above-mentioned entities would be regarded as an AIFM. According to the definition set out in Art. 4 (1) (c), (x) and Appendix I AIFMD, the AIFM is the entity which assumes portfolio and risk management at least. Strictly speaking, there is no portfolio management in NTCEFs, as the fund usually focuses on a single asset. Furthermore, the management of a typical NTCEF is specifically not authorised to

buy or sell. Decisions of this type may only be made by the General Meeting. Further, there is usually one asset manager whose principal task lies in managing the fund asset, e.g. the property manager or vessel owner. In this respect, one may talk about active asset management and static portfolio management. Even though these terms are not absolutely accurate, we work on the assumption that the issuing house or a subsidiary will be viewed as an AIFM because they alone are responsible for deciding the level of resources required to ensure independent performance of services. According to the scope of the AIFM Directive, the legal structures of AIFMs and AIFs are of no importance, so, according to the rules of delegation, the authorised entities must logically be attributed to the issuing house or associated company as the AIFM.

Applicable law: As already mentioned, mutual funds are subject to an obligation under the German Law on the Prospectus for Securities Offered for Sale (Wertpapier-Verkaufsprospektgesetz – VerkProspG) to draw up a sales prospectus and have it approved. This obligation is not based on the Prospectus Directive, which does not apply to NTCEFs. Beyond that, there are no special national statutory provisions⁴ for NTCEFs. As regards their legal form, most NTCEFs are organised as a GmbH & Co. KG. On acquiring a holding, the investor becomes a limited partner (or trustor) in the investment company under civil law, and a co-entrepreneur for tax purposes. The holding may give rise to tax obligations even if there is no capital flow. Further, investors enjoy far-reaching rights of co-determination and, by exercising their voting rights at the General Meeting, may actively shape fund decisions and strategies. Subject to a majority, investors may decide on all matters, in particular the sale of the investment asset, and hence the dissolution of the fund. Thus the legal relationships are primarily governed by the partnership agreement and individual investor agreements. In that respect, German civil and corporate law apply above all else. In terms of liability law, there is comprehensive jurisprudence, accumulated over many years, on the completeness and correctness of sales prospectuses, and obligations in matters of sales-related advice.

Besides the obligation to publish a prospectus, there are no other supervisory-related regulatory requirements (such as, for example, the Investment Act for open-ended funds). Neither do European regulations (such as MiFID, the UCITS Directive, the Prospectus Directive, the Transparency Directive, the Market Abuse Directive, etc.) apply to NTCEFs in Germany. The trade of shares in NTCEFs is very restricted; in particular, shares cannot be traded on a stock exchange, which is why they cannot be classed as securities. Existing European capital market rules basically tie in with this characteristic. Diverging from this, the AIFM Directive ties in with the manager characteristic, making it the first European regulatory regime to embrace NTCEF business as part of the European capital market.

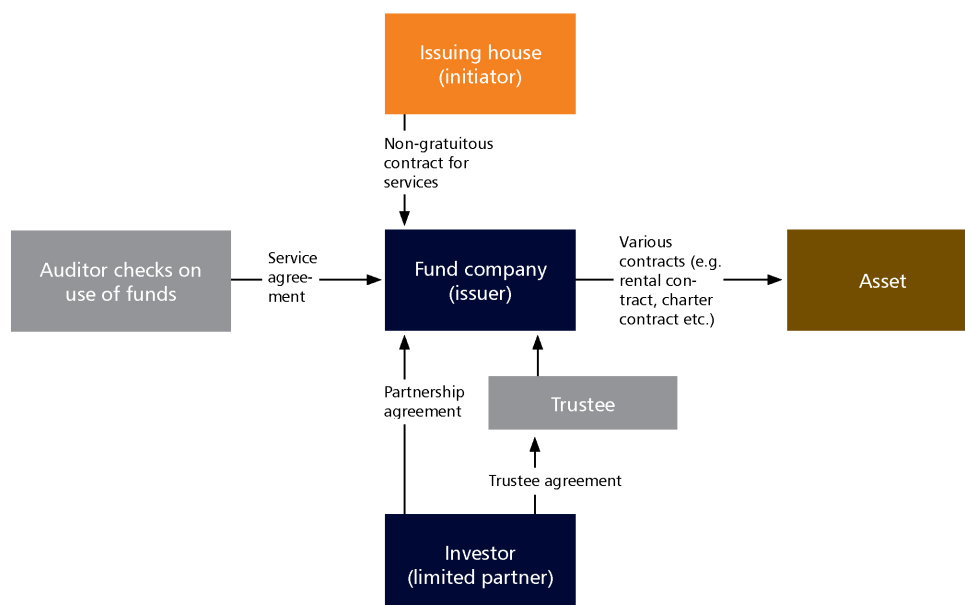
⁴ The German legislator is currently planning specific statutory regulations for NTCEFs, particularly with regard to marketing and sales.

In addition to the statutory regulations, the vast majority of NTCEF suppliers – measured by volume – have imposed a plethora of rules on themselves through voluntary commitments. These are an essential prerequisite for membership of the VGF, which has come to be regarded as a mark of quality. Commitments include, in particular:

- an obligation to produce and publish track records (annually published records of all the results of funds under management, so-called “Leistungsbilanzen”)⁵,
- an obligation to have the content of sales prospectuses checked by an accountant with reference to an accounting standard (‘IDW S4’)
- obligation to join the NTCEF ombudsman (“Ombudsstelle Geschlossene Fonds”).⁶

The current lack of special legislation means that, in many instances, new regulatory ground will have to be broken. It is all the more important, therefore, to ensure careful weighing up of new rules for markets and products which have traditionally been lightly regulated. This should be borne in mind when drawing up the implementing measures on the AIFM Directive.

Overview of the legal relationships in NTCEFs:



⁵ For further information: www.leistungsbilanzportal.de

⁶ For further information: www.ombudsstelle-gfonds.de

Question 2:

Among the topics that will be covered by the implementing measures, which do you consider would be most appropriately adopted in the form of regulation or directives? Please explain your choice.

The AIFM Directive implementing measures should take into account the special features of all products and managers concerned. Given that the broad scope of the Directive will cover many actors and products, appropriate attention should be given to differences in the management of alternative investment funds. One therefore needs to examine the specific needs of each type of business. Urgent differentiation is required for German NTCEFs given that they differ substantially from open-ended funds in particular: as a general rule, managers of NTCEFs focus solely on managing the fund as the investment assets have usually been acquired before the fund is launched. Even with blind pools, the fund management simply executes a pre-defined investment strategy – but is not responsible for defining that strategy. Contrary to open-ended funds, managers have no scope for independent decision-making, or, in the case of blind pools, only very limited scope for decision-making with respect to the way the fund is invested. All fundamental decisions are voted by the investors via formal shareholder resolutions taken at the General Meeting.

In our view, future rules must take account of these peculiarities. NTCEFs of the German type are a specifically German product. There are closed-end funds in other EU member states, of course, but they are not structured as partnerships. It is typical of German NTCEFs that their shares cannot be traded on a stock exchange, and assets are fixed over the entire duration of the fund. In other countries, shares may usually be traded on stock exchanges and assets are not permanently fixed. In this case, choosing and trading shares is part of the business model. NTCEF managers therefore pursue an entirely different business model in that they perform totally different work and are exposed to different risks.

Our worry is that Level 2 measures imposed via regulations will not pay sufficient attention to these national characteristics. We therefore support solutions based on directives. That would leave national legislators with enough scope to cover own products and market structures in an efficient manner. Such a tailored approach would be virtually impossible through regulations. We do not believe this would harm attempts to achieve the highest possible degree of harmonisation. The AIFM Directive itself contains many detailed rules, providing a very clear framework. The implementing measures should nevertheless be precise enough to prevent nation-by-nation dissection of the intended system of control.

Regulations on licensing and obligations of transparency towards investors and the authorities could certainly be envisaged. We believe all material requirements,

e.g. in respect of risk management, governance obligations and depository obligations should definitely be covered by directives.

To conclude, we would like to add that the product in its specifically national configuration also appeals to fund suppliers in EU countries outside Germany. This is reflected in the fact that, in 2010, a further two companies based in EU states outside Germany, recognising the advantages of German NTCEFs, were accepted as VGF members. Hence the call for differentiated rules implies no attempt at compartmentalisation, but rather an openness to the idea of European competitors also doing business in Germany.

Question 3:

Can you identify useful sources of data and statistical evidence from which CESR could benefit in the preparation of its advice?

The VGF has been compiling industry figures for the NTCEF market in Germany since 2008. The figures are published annually, usually in February of the year after the year under review. Figures are collected not just for VGF member companies, but for the entire NTCEF market. The volume of funds invested (equity capital placed) by investors in NTCEFs is an important parameter, as is the distribution of said funds across asset classes and target markets. The VGF figures also provide information about the structure of subscribers, e.g. subscriber age distribution, and percentage of institutional investors. Besides the annual results, the VGF figures also provide information about the volume of funds currently invested in NTCEFs. The fund volume managed under NTCEF structures totalled some EUR 164 billion as of 31.12.2009, for example. The VGF has no financial interest in compiling industry figures: results are provided to market participants free of charge at www.vgf-branchenzahlen.de. For detailed evaluations, own statistics can be generated using an analytical tool available online.⁷

The VGF also publishes data of the NTCEF market over the course of the year. The association publishes quarterly figures indicating the volume of new equity capital placed by its members.

⁷ We are happy to provide ESMA with free access to this analytical tool. Therefore please contact Mr Gero Gossler at Brussels office (gossler@vgf-online.de, P. +32 (0) 2.5501614, F. +32 (0) 2.5501617)

Comments on the Provisional Request to CESR for Technical Advice on Possible Level 2 Measures concerning the Future Directive on Alternative Investment Funds Managers

Please note the following comments with regard to the provisional request. These comments relate solely to the following problems, i.e. the major problems for NTCEFs at this time:

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Issue 1b): Article 3 Thresholds – Calculation, oscillation, obligation below thresholds

Question 1: CESR is requested to advise the Commission on how to identify the portfolios of AIF under management by a particular AIFM, and the calculation of the value of assets under management by the AIFM on behalf of these AIF.

As a general rule, NTCEFs do not manage portfolios; they manage individual investment assets. The value of these assets should be calculated using the criteria outlined in the implementing measures described in Art. 19 AIFMD.

Question 3: CESR is invited to consider how the use of different forms of leverage influences the assets under management by an AIF and how this should be taken into account in the calculation of assets under management.

It should be borne in mind that external capital in NTCEFs will usually take the form of loans provided by credit institutes to finance the investment. On average, external capital makes up 50% of a NTCEF. The loans are largely paid off during the lifetime of the fund. As mentioned, loans do not fulfil a lever function as is often the case in other capital market products, rather they follow the refinancing sums typical of the particular asset class. The percentage of external capital in the

fund will tend to decrease over the lifetime of the fund. For details, we refer you to Answer 1 in the Call for Evidence (paragraph entitled External Financing). When applying for licensing, AIFMs have to provide information on, amongst other things, the key characteristics of the fund to be managed. This should give a clear indication of the amount and type of external capital to be used.

Issue 3: Article 12 General principles

Question 1: *CESR is requested to advise the Commission on criteria to be used by the relevant competent authorities to assess whether AIFM comply with their obligations under Article 12 (1).*

When drawing up general principles, one should consider tried-and-tested criteria. Besides the trustworthiness of the acting persons these should naturally also include specialist skills as evidenced by professional experience. One should also bear in mind that German NTCEFs have thus far not been subject to any supplier regulations. A simple procedure of recognition should therefore be introduced to ensure seamless continuation for current NTCEF managers under the AIFM regime.

Issue 5: Article 15 Risk Management

Question 1: *CESR is requested to advise the Commission on the risk management systems to be employed by AIFM as a function of the risks that the AIFM incurs on behalf of the AIF that it manages and on the criteria that competent authorities should take into account when assessing for the AIF managed by the AIFM whether the risk management process employed by the AIFM is adequate in order to identify measure, manage and monitor appropriately all risks relevant to each AIF investment strategy and to which each AIF is or can be exposed.*

The risks associated with NTCEFs differ fundamentally from those associated with other forms of investment. The funds generally invest in a pre-defined single asset which is acquired before preparation of the sales prospectus and the start of sales. During the lifetime of the fund, the fund manager's responsibility is limited to managing the fund - except in the case of blind pools. There are no further purchases or sales. Hence the risk potential exists primarily in the fund conception phase - when choosing the asset or securing of financing, for example. At that point, however, no AIF exists as yet, so there is no investor money under management. Later on, the risk situation described in detail to the investor in the sales prospectus remains relatively static. The implementing measures relative to the AIFM Directive should take this into account.

Question 1a): *In particular, CESR is requested to advise on the categories of risk relevant to each AIF investment strategy, and to which each AIF is or can be exposed, and the methods for identifying the risks that are relevant for the particular AIF investment strategy or strategies so that all risks are adequately identified.*

There are three categories of possible risks:

Cost risks are conceivable in the fund initiation phase. A real estate fund, for example, may incur financing, building and purchasing risks. These risks impact mainly on the AIFM, however, not the AIF. The AIF will incur cost risks associated with the ongoing management of the investment asset, e.g. cost of repair and maintenance to the property.

Revenue risks exist primarily during the lifetime of the fund. With a real estate fund, for example, there is the risk that the property remains unlet. There are tenant risks, too, in case of any changes in tenant credit standing, for example. Risks also exist at the end of the fund's lifetime, e.g. when selling the property or letting to new tenants.

Value risks tend to be influenced by circumstances beyond the AIFM's control. Change in value risks may depend on market or location. One may also have to bear in mind force majeure risks and political risks (e.g. legal security). There may be currency risks where assets are purchased in foreign currencies.

Individual risks differ both in terms of the phases in which they occur and in terms of the legal entity tasked with handling. In the initiation phase, the issuing house typically bears the greatest risk. Risks tend to be asset-related over the lifetime of the fund.

Question 1b): *In particular, CESR is requested to advise, to the extent possible, on methods for quantifying and measuring risks including the conditions for the use of different risk measurement methodologies in relation to the identified types of risk so that overall risk exposures as well as contributions to overall risk from each risk factor are properly measured.*

Risk measurement methods should be designed to correctly determine the risks associated with NTCEFs. One must take into account that the AIFM generally has very limited scope for reaction. All fundamental fund decisions (sale of asset, for example) are made by the investors at the General Meeting, and are not matters for the AIFM. Methods must reflect this special AIFM risk profile.

Question 2: *CESR is requested to advise the Commission on the appropriate frequency of review of the risk management system. CESR is invited to consider*

whether the appropriate frequency of review varies according to the type of AIFM or the investment strategy of the AIF.

One needs to ensure that risk management requirements can also be met by smaller NTCEF suppliers. Reviews of risk management systems should only be required following significant changes in business circumstances, when the original risk management system may no longer adequately identify and address actual risks. Presumably, this would occur principally if action by the management were to create new risks modifying a situation which had been essentially static to that point. The frequency of review should be feasible if the method takes account of the specifics of NTCEFs.

Question 3: *CESR is requested to advise the Commission on the conditions for the appropriate risk governance structure, infrastructure, reporting and methodology, in particular, on how the risk management function shall be functionally and hierarchically separated from the operating units, including the portfolio management function.*

The following practical factors should be borne in mind when considering the functional separation of risk management and portfolio management: the risks associated with NTCEFs are typically asset-related. As a general rule, only asset managers will be capable of identifying these asset risks. These managers are part of the fund management, and are included amongst the AIFM's operating personnel. Risks must therefore always be monitored and evaluated at fund level. At this level, we believe it will prove impossible in many cases to separate this activity from that of portfolio management, if only for practical reasons. Functional separation as per the AIFM Directive could be ensured by setting up a central risk management team to check and, if necessary, reassess, risk evaluations by asset managers.

Question 4: *CESR is requested:*

a) to advise how the principle of proportionality is to be applied by competent authorities in reviewing the functional and hierarchical separation of the functions of risk management in accordance with Article 15(1).

b) to advise on criteria to be used in assessing whether specific safeguards against conflicts of interest allow for the independent performance of risk management activities and that the risk management process satisfies the requirements of Article 15 and is consistently effective. This advice will be particularly relevant in cases where full separation of functions is not considered proportionate. CESR is encouraged to provide the Commission with a non-exhaustive list of specific safeguards AIFM could employ against conflicts of interest referred to in the second subparagraph of Article 15(1).

Exceptions from a strict separation of functions should be allowed when the risks involved are relatively low, and disproportionate to the additional personnel-related costs. Otherwise, mandatory functional and hierarchical separations may lose their sense. In our view, suppliers of NTCEFs, and smaller suppliers in particular, should not be prevented from remaining in business due to organisational reasons. Many already operate an effective risk management system, and the AIFM Directive is likely to make the measures currently in place even more stringent. Companies, and small companies in particular, should only be required to comply with additional organisational and personnel requirements if the spirit and purpose of functional separation cannot be achieved equally well in some other way. We believe that this spirit and purpose could be fulfilled, in particular, by creating an independent risk management system. Such independence could also be verified through other disclosure obligations, for example. As long as the basic principles governing the identification, evaluation and monitoring of risks are demonstrably applied, we do not believe there is any need for mandatory separation of functions.

Issue 6: Article 16 Liquidity management

Requirements in terms of a liquidity management system are negligible for NTCEFs, as investors have no redemption rights. There is no need, therefore, for liquidity to be available to investors during the lifetime of the fund. With this regard, stress testing remains unproportional, because the liquidity of NTCEFs cannot lead to any kind of macro economic distortion at all. Asset-related liquidity is a different matter, and must naturally be available to ensure effective asset management. The implementing measures of the AIFM Directive should make it clear that, in this case, liquidity management requirements need only be minimal.

Issue 9: Article 19 Valuation

***Question 1:** CESR is invited to advise the Commission on the criteria concerning the procedures for the proper valuation of the assets and the calculation of the net asset value per share or unit to be used by competent authorities in assessing whether an AIFM complies with its obligations under Article 19(1) and Article 19(3). CESR is invited to consider how these procedures should be differentiated to reflect the diverse characteristics of the assets in which an AIF may invest.*

Above all, asset and share valuation methods should take different classes of asset into account. NTCEFs typically invest in real estate, aircraft, ships, renewable energies and private equity. This variety means a static valuation method is unfeasible. A better idea would be to create certain standard methods. Current valuation standards could be used as a basis, although not all of them are

anchored in law. In Germany there is national legislation such as the Real Estate Valuation Ordinance (Immobilienwertermittlungsverordnung), which could be used to determine the value of the asset, at least. In the real estate branch, for example, the Income Value Approach (Ertragswertverfahren) and Discounted Cash Flow method (DCF) are widely used. In the shipping industry, asset values are reflected in the Long Term Asset Value (LTAV), for example, which follows actual market value.

There are no share valuation rules or standards that we know of. The implementing measures relating to the AIFM Directive should therefore recognise the need to develop certain valuation methods. Valuation methods should also take account of the diversity of asset classes. Above all, however, it is important to remember that 'net asset value' should be understood purely as a mathematical derivative of the asset value determined before.

Issue 10: Article 20 delegation of AIFM functions

In NTCEFs, the management functions listed in Annex I of the AIFM Directive are usually executed by different entities. Most of the time, responsibility for the various tasks is divided amongst different subsidiaries or sister companies of the issuing houses. One commonly finds, for example, independent companies which handle investment management in particular, or asset management. Involving external third parties has also become common practice. External auditors are usually appointed to carry out the customary checks on how funds are used, for example. Further, a large portion of funds are sold to investors through external channels.

The German Sales Prospectus Act (Wertpapier-Verkaufsprospektgesetz – VerkProspG) and the Investment Sales Prospectus Ordinance (Vermögensanlagen-Verkaufsprospektverordnung – VermVerkProspV) already stipulate a requirement to name the key persons and companies associated with the fund in the prospectus, including managing directors and shareholders. This obviously includes all persons and companies involved with the management function. As a general rule, any changes in this respect must be notified. This provides supervisory authorities and investors with firm information about the companies involved in fund management. In the case of Group companies, it is not unusual for information to be given about the company shareholder structures. The obligation to publish a prospectus, and hence to update original information, ends when the fund is dissolved. In this respect, an obligation to report to the supervisory authorities in line with the existing obligation to provide updates would be feasible.

The implementing measures relative to the AIFM Directive should take account of the fact that the liability incurred by the AIFM does not diminish even if tasks are

delegated to third parties. Responsibility for fund management remains with the AIFM. In this respect it is in the AIFM's own interest to ensure third parties are selected with the necessary care, even if only to avoid liability to himself. Nevertheless, the AIFM cannot give any guarantee of correct execution of duties. Such a high liability standard would scarcely be insurable. From the perspective of NTCEFs, the requirements of the implementing measures should therefore state specifically that only the act of selecting the delegate must be properly undertaken. In our view this will require specific prerequisites providing a precise definition of when a delegate may be considered to have been properly selected.

Issue 13.1 Depository functions pursuant to paragraph 6

Question 1: *CESR is requested to advise the Commission on the conditions for performing the depository functions pursuant to Article 21(6). CESR is requested to specify conditions for the depository to ensure that:*

- *the AIFs cash flows are properly monitored;*
- *all payments made by or on behalf of investors upon the subscription of shares or units of - an AIF have been received and booked in one or more cash accounts opened in the name of the AIF or in the name of the AIFM acting on behalf of the AIF or in the name of the depository acting on behalf of the AIF at an entity referred to in Article 18 (1) (a) to (c) of Commission Directive 2006/73/EC in accordance with the principles set forth in Article 16 of Commission Directive 2006/73/EC.*
- *where cash accounts are opened in the name of the depository acting on behalf of the AIF, none of the depository's own cash is kept in the same accounts.*

In the investment phase, NTCEF cash flows are already monitored on a regular basis by means of checks on use of funds. This is often done by independent auditors. Issuing houses allied with banks may also entrust other subsidiary companies with this task.

When drafting implementing measures relative to the AIFM Directive, one should bear in mind that NTCEFs are subject to Art. 21 (3) 2nd sub-section of the AIFMD. According to this, member states may allow to entrust depository duties of NTCEFs to a professionally regulated entity. Hence these entities must also be able to meet control mechanism requirements. The rules on depository set out in the AIFMD are aimed above all at providing formal monitoring of cash flows. This, plus correct posting to separate accounts, should not pose any insurmountable hurdles for the entities acting as depository. If further work on Level 2 measures indicates that monitoring of cash flows and ownership structures requires a standardised, industry-wide scheme, we request that adequate consideration be given to the above-mentioned special characteristics of NTCEF depositaries. We believe it would be useful and practical if auditors and comparable professional

groups - who, acting in line with current NTCEF practice, already control the use of funds - were permitted to exercise the function of depositary under the AIFMD.

Issue 13.2 Depositary functions pursuant to paragraph 7

Question 2: *CESR is requested to advise the Commission on:*

- *the type of "other assets" with respect to which the depositary shall exercise its safekeeping duties pursuant to paragraph 7(b), namely all assets that cannot or are not to be kept in custody by the depositary pursuant paragraph to Article 7(a);*
- *the conditions applicable to the depositary when exercising its safekeeping duties over such "other assets", taking into account the specificities of the various types of asset, including but not limited to financial instruments issued in a 'nominative' form, financial instruments registered with an issuer or a registrar, other financial instruments and other types of assets.*

We wish to point out that the investment assets of NTCEFs should be regarded as "other assets" in line with Art. 21 (7) (b) AIFMD. Generally speaking, the assets are not financial instruments, but at most physical investment objects such as real estate, aircraft, ships, etc. Hence they cannot be left in a deposit for safekeeping.

Question 3: *To that end, CESR is requested to advise the Commission on:*

- *the conditions upon which the depositary shall verify the ownership of the AIF or the AIFM on behalf of the AIF of such assets;*
- *the information, documents and evidence upon which a depositary may rely in order to be satisfied that the AIF or the AIFM on behalf of the AIF holds the ownership of such assets, and the means by which such information shall be made available to the depositary;*
- *the conditions upon which the depositary shall maintain a record of these assets, including but not limited to the type of information to be recorded according to the various specificities of these assets; and the conditions upon which such records shall be kept updated.*

In Germany, ownership of property is recorded in an official public register known as the land register (Grundbuch). The entry includes information about associated rights (e.g. priority notices and rights of pre-emption) and any encumbrances on the property (e.g. mortgages, servitudes). Similar registers exist in the shipping and aviation industries. It is possible, therefore, to obtain information about owner status if one can demonstrate a legitimate interest. Where funds hold assets which are not recorded in these types of registers, e.g. private equity funds with investments in German companies, interested parties may apply for extracts from the relevant commercial register (Handelsregister). In

this case, the register may be consulted without even having to demonstrate a legitimate interest.

Safekeeping and regular updating of these documents by a depository would not seem to pose any particular problems. Regarding assets outside Germany, similar registers are available in other member states, as they usually are in non-member states, too. The European Land Information Service EULIS (www.eulis.eu) can provide further information about the European registers.

Issue 19: Article 4 Definition of Leverage

***Question 1:** CESR is requested to provide the Commission with a description of relevant methods by which AIFM increase the exposure of AIF whether through borrowing of cash or securities, or leverage embedded in derivative positions or by any other means, including any financial and/or legal structures involving third parties controlled by the AIF. This description or mapping should distinguish between the various business models and approaches to leverage in the AIFM industry. In its advice, CESR should take into account the guidance provided in recital 14.*

As said before NTCEF investment objects are often financed with a percentage of external capital. Some two-thirds of the funds launched in 2008 and 2009 were underpinned with external capital. External capital usually makes up some 50% of the fund volume. It may be more or less, depending on the asset class, but it is very rare that the percentage of external capital exceeds 75%. There are also funds with no external capital at all. External capital usually takes the form of loans from credit institutions which are paid off during the lifetime of the fund. Their sole purpose is to provide the capital required to finance the fund asset. Low volumes of external capital are typical of NTCEFs; at around 50%, they have more in common with traditional financing structures. This conservative use of external capital should be borne in mind when defining leverage in more detail. NTCEFs generate their yields from the assets in which they invest, not by using financial-mathematical methods. High leverage ratios would mean higher bank margins; hence they would only make sense if one were counting on asset appreciation - but this is not a prime aspect of long-term asset management. Further, any increase or change in the use of external capital during the lifetime of a NTCEF must be formally approved by the General Meeting, i.e. by a majority of investors. A manager of a NTCEF cannot make sole decisions about the use of new external capital, or about changes to the scope of current external capital-related obligations, especially not when the volumes in question are large. In NTCEFs, this means that short-term speculative transactions based on external capital, i.e. transactions which could result in systemic adverse effects, are impossible from the outset.

Question 2: CESR is requested to advise the Commission on the appropriate method or methods for the calculation of leverage for the purpose of this Directive. The analysis should, inter alia, take into account the appropriateness, accuracy, cost, comparability and practicability of the different methods.

With NTCEFs, a leverage effect is usually achieved through long-term loans. In our view, appropriate leverage limits should be set with reference to the customary key financing figures, e.g. debt service coverage ratio (DSCR). We believe rigid limits on the maximum uptake of external capital are not appropriate as the projects vary greatly.

Issue 20: Article 22 Annual report

In line with German commercial law, NTCEFs are normally subject to an obligation to provide an annual report. In this respect, the German Commercial Code (Handelsgesetzbuch, HGB) defines far-reaching requirements with regard to individual reporting obligations. Specifically, the rules on preparing and auditing balance sheets, statements of profit and loss and management reports should remain in place following implementation of the AIFM Directive in order to preserve the consistency of decades of practice. Some years ago, the VGF also initiated its own standard to measure NTCEF supplier performance by fund development (so-called "Leistungsbilanzstandard").⁸ Track records allow investors and supervisory authorities to follow fund development with reference to a target/actual comparison in which forecast results are plotted against actual results. Track records are compiled with reference to industry guidelines. Track records are a prerequisite condition of membership of the VGF. With regard to implementing measures for the AIFM Directive, we suggest that VGF track records may be helpful in structuring reporting obligations. Over the years, these track records have proved an effective means of illustrating supplier quality to a broad public. They also accurately show the trends amongst NTCEFs, which operate under different reporting criteria to open-ended funds. Questions previously raised by the Commission regarding e.g. a declaration relating to fund investments during the year under review (Issue 20, Question 4) are not relevant to the business model of NTCEFs, which usually invest in only one clearly defined asset.

Issue 21: Article 23 Disclosure to investors

Question 1: With respect to the disclosure obligations in Article 23(4), CESR is requested to advise the Commission on:

⁸ For further information: www.leistungsbilanzportal.de.

- *the appropriate frequency of such disclosures;*
- *the criteria for assessing the liquidity of assets and procedure for calculating the percentage referred to in Article 23(4)(a) and the format of such disclosures; the information and the essential elements to be included in the description of the arrangements referred in points a) and b) of Article 23(4) including the use of gates, suspensions and side pockets; the essential information, and the format thereof, of the risk factors, including relevant risk measures and metrics used to assess the sensitivity of the AIF portfolio to movements in interest rates, credit spreads, equity markets, etc, counterparty risks the extent of rehypothecation and information on indebtedness of entities controlled by the AIF to be disclosed by the AIFM to enable appropriate description of the current risk profile of the AIF; and*
- *the information and the essential elements to be disclosed by the AIFM to enable appropriate description of the risk management systems employed by the AIFM to manage these risks including results of recent stress tests.*

We shall limit our comments to the rules with regard to Art. 23 (4) (c) AIFMD. The risk management reporting requirement should be fixed at once yearly. As already set out under Issue 5, Question 2, the key features of risk management are not likely to change in the short term. There should be a requirement to report during the year if there are any substantial changes.

With regard to possible changes to liquidity management rules, we wish to repeat that liquidity management requirements for NTCEFs need only be very low given that investors in these funds do not enjoy any right of redemption. For further information, we refer you to our comments on Issue 6.

Question 2: *With respect to the disclosure obligations in Article 23(5), CESR is requested to advise the Commission on:*

- *the appropriate frequency of such disclosures;*
- *the essential information, and the format thereof, to ensure an appropriate description of changes to the maximum level of leverage which the AIFM may employ on behalf of the AIF as well as any right of re-use of collateral or any guarantee granted under the leveraging arrangement; and the leverage measures or ratios, and the format thereof, to be used by the AIFM when disclosing the total amount of leverage employed by the AIF during the reporting period and at the end of the reporting period including those specified according to Article 4.*

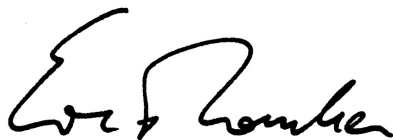
We would like to point out here that NTCEFs frequently contain external capital, and therefore the term 'leverage' has always been used. Nevertheless, we are

dealing here with loans to finance the fund object, not a complex trading technique aimed at generating greater revenues through large sums of external capital. We believe there should therefore be a differentiated assessment of whether there is actual use of leverage or whether external capital is simply being used to finance an investment, as would be usual for, say, private housing construction. The percentage of external capital in NTCEFs is, on average, around 50%. Loans are regularly paid off during the lifetime of the fund. The AIFM reports to investors on this at least once a year, at the General Meeting. Given that the proportion of external capital decreases over the lifetime of the fund (repayment), more frequent intervals do not appear to be necessary for NTCEFs.

Issue 22: Article 24 Reporting obligations to competent authorities

Reporting obligations to competent authorities are already set out in the AIFM Directive. We shall therefore comment primarily on reporting frequency. With low-volatility business structures such as NTCEFs, the reporting frequency should be as long as possible. There is no reason to supply the requested information at short intervals as the investment strategy is a long-term one, so there will be very few changes worth reporting during the year. It seems appropriate, therefore, to tie the reporting deadline in with the annual obligation to prepare and publish an Annual Report. This is all the more relevant in the light of Art. 24 (6) (b) AIFMD, according to which the implementing measures should not lead to the creation of excessive administrative hurdles.

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