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IMPACT ASSESSMENT

Accompanying the document

COMMISSION DELEGATED REGULATION

supplementing Directive 2011/61/EU of the European Parliament and of the Council with regards to exemptions, general operating conditions, depositories, leverage, transparency and supervision

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1. INTRODUCTION

The subject of this impact assessment report is the so-called level 2 measures of the AIFM Directive, which are intended to specify certain aspects of the framework directive in view of its consistent implementation throughout the Union. As not all of these measures are expected to have significant impacts over and above those already caused by the AIFMD, specific attention is given to those measures for which more important impacts are to be expected. For all others a short description and assessment is provided in Annex 7.

1.1. The Framework Directive (AIFMD)

The Directive on Alternative Investment Fund Managers[1] (AIFMD) introduces for the first time in the Union harmonised requirements for entities engaged in the management and administration of alternative investment funds (AIF).[2]

It regulates the management of alternative investment funds and the marketing of these funds to professional investors in the EU.[3] Member States may impose additional requirements for the marketing of AIF to retail investors. The sale of units or shares on the initiative of the investor ('passive marketing') is not covered, and therefore remains under national law.

The Directive covers all kinds of AIF and their managers (AIFM), ranging from simple equity funds to funds investing in specific, illiquid assets like real estate, private equity, infrastructure, commodities or goods like wine or art. It covers all possible investment strategies and legal forms.

AIFM have to be authorised, and to obtain this authorisation they have to comply with the requirements of the Directive. They range from, amongst other areas, requirements on capital, risk and liquidity management, obligation on the appointment of a depositary, who, in turn, has to comply with strict rules, to rules regarding disclosures to investors and reporting to competent authorities.

1.2. The investment fund sector

With the AIFMD, all investment funds in the EU fall into one of the following two categories: They are either UCITS (undertakings for collective investment in transferable securities) or AIF. UCITS funds are those that comply with harmonised rules as laid down in the UCITS Directive (2009/65/EC) which permit their sale to the retail market.[4] They are not the subject of this IA report.

While the UCITS fund sector, with almost 6trn€ of assets under management in the EU, is much larger than the AIF sector, the latter nevertheless manages assets worth almost 2.2trn€

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[1] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:0073:EN:PDF

[2] A glossary of the technical terms used in this report can be found in Annex 1. Annex 2 provides a short description of the AIFMD.

[3] The AIFMD also covers the marketing of AIF established in third countries to professional investors in the Union as well as the management of AIF established in the Union, even if they are not marketed to investors in the Union.

[4] Annex 2 describes the differences between UCITS and AIFs and how the UCITS Directive and AIFMD work together.

(end September 2011). The assets under management within AIF amount to 18% of the EU's GDP or more than the GDP of France or the United Kingdom in the year 2010. More than two thirds (68%) of the assets of AIF are held by institutional investors, 70 per cent of which are comprised of pension funds and insurance companies.

It is important to note that many AIF are managed by external managers. This holds in particular for hedge funds, where the manager might be based in the EU while the fund is domiciled in, say, the Cayman Islands, to name a typical case.

2. PROCEDURAL ISSUES AND CONSULTATION OF INTERESTED PARTIES

2.1. Procedural issues

The AIFMD makes provision for a very extensive set of delegated acts and implementing measures covering a wide range of topics.[5] While it does not contain specific deadlines for the delivery of these measures, it is good practice to deliver the entire package of implementing legislation one year before the end of the transition period in July 2013, in order to allow sufficient time for transposition and implementation by Member States and the industry.[6]

On 2 December 2010, the European Commission sent a request for technical advice on the level 2 measures in the AIFMD to the Committee of European Securities Regulators (CESR). The European Securities and Markets Authority (ESMA, which replaced CESR as of 1st of January 2011) transmitted its technical advice to the European Commission on 15 November 2011.[7]

2.2. External expertise and consultation of interested parties

Throughout the process of drafting its advice, ESMA was in close contact with the industry through bilateral meetings, while it also provided for several occasions where of all kinds could express their views and provide information including through formal public consultations. Stakeholders showed great engagement from the start of the discussions on level 2 measures at ESMA, as evidenced in the great number of responses ESMA received to its written consultations (see table below).

[5] In the following the terms 'level 2 measures' and 'implementing measures' are used interchangeably, for this IA report they comprise all 'delegated acts' and 'implementing acts' covered by the Commission's mandate to CESR/ESMA, but not regulatory or implementing technical standards and guidelines which ESMA will have to develop on its own initiative and which have not to be impact assessed by the European Commission. The acronym 'AIFMD' on the other hand is used to refer to the level 1 framework Directive. Annex 4 provides a complete list of all implementing measures, technical standards and guidelines.

[6] A table summarising the timetable of AIFMD Level 2 work is provided in the second part of Annex 2.

[7] http://www.esma.europa.eu/system/files/2011_379.pdf

Table 1: ESMA consultations

Consultation	*Consultation period*	*Number of responses*
Call for evidence on the European Commission's request for advice	3 December 2010 – 14 January 2011	51
Discussion paper on ESMA's policy orientations on possible implementing measures under Article 3 of the AIFMD	15 April – 16 May 2011	15
Draft technical advice	13 July – 13 September 2011	around 100
Draft technical advice regarding supervision and third countries	23 August – 23 September 2011	around 50

The consultation documents and the responses that were cleared for publication can be found at the ESMA website. The feedback statement can be found in the Annex 14.

In addition to the written consultations, ESMA organised three open hearings covering the Call for Evidence and the two parts of the draft technical advice, the first in January and the second two in September 2011. Summaries of these hearings as prepared by ESMA are attached to this impact assessment report. Furthermore, ESMA organised a series of targeted workshops on the different parts of the technical advice between March and May 2011. These workshops were not open to the public but only upon invitation. They brought together some fifteen to twenty industry experts on the respective subjects as selected by ESMA.[8]

ESMA invited stakeholders to provide data and other quantitative evidence across all of its consultations, hearings and workshops. Little quantitative evidence was provided to support views, however, other than anecdotal evidence. However, a wealth of qualitative assessments has been presented in extensive discussions with national supervisors and stakeholders, in particular from representatives of trade associations, of fund managers, depositaries and others from Member States as well as from third countries such as the Channel Islands, the Caribbean financial centres, the United States and Switzerland.

The reluctance or inability to provide data can be explained, at least partially, by the fact that many of the issues are either sensitive to individual businesses and thus AIFM and depositaries are reluctant to reveal data, or are so specific or novel that relevant data or information was not available within companies as they do not gather such information for their ordinary business.

2.3. How the opinion of the Impact Assessment Board has been taken into account

The draft IA report has been examined by the Impact Assessment Board (IAB) in written procedure in February/March 2012. On the basis of the IAB's opinion of 16 March 2012 the draft IA report has been revised in order to take into account the views of the IAB.

In order to **clarify the scope of the initiative**, some more background on the initiative has been provided in annex 2. In the chapter on 'options' the limitations set by the AIFMD have been explained in more detail. The analysis of impacts includes some discussion of the extent

[8] As it was the case in earlier consultations and hearings on asset management organised by the European Commission or CESR in previous years, it was primarily the 'supply side', i.e. AIFM and, in parts, depositaries, that participated. The few responses from the 'buy side', i.e. investors, came from big players in the market like pension funds. Smaller and mid-size investors were represented through the Stakeholder Groups of ESMA which responded to the consultations or hearings. These representatives took also potential adverse impacts on retail investors into account but did not voice any major concerns.

to which impacts are triggered by level 1 and by level 2. However, because of the lack of data this could only be done at a high level of abstraction and qualitative reasoning, not substantiated by figures.

The suggestion to **strengthen the analysis of impacts** with quantitative could not be followed as such information was not to be obtained by the industry or supervisory bodies or any other third party. Both, ESMA and the European Commission, have invited the different parts of the industry (AIFM, depositaries, investors, etc.) on many occasions to substantiate their views or positions with quantitative information in order to allow the Commission to underpin its proposals with quantitative assessments. However, the necessary data still did not become available as stakeholders were reluctant or not capable to provide such data, primarily for business secrecy reasons but also because such data could not easily be extracted. And even where ESMA or the Commission had received anecdotal evidence this did not allow drawing robust general conclusions in extrapolating these few evidences as up to now the situation is very different between types of AIFM, Member States, and third countries.

With regard to the measuring of impacts against the status quo the following has to be taken into account: Firstly, the status quo, i.e. the situation in 2012, would ignore the impacts the implementation of the level 1 Directive will have after July 2013. Secondly, the status quo consists of a patchwork of national rules and, in some cases, a lack thereof for managers of what will be AIF as of 2013. This would mean that hundreds of possible cases, depending on the legal form, the investment strategy, the assets, the Member State of domicile, marketing (public or private), would have to be analysed. Similar exercises in forms of expert groups or studies with a much more limited scope in the past showed that it would not be possible to produce only a rough picture of the legal framework, not to mention one of the level of detail that would be required for the AIFMD level 2 work.[9] In short, using a status quo as benchmark which would be obsolete anyway as it ignores other developments (level 1) and which would require tremendous financial and human resources seemed not proportionate and inappropriate for the exercise at hand. The more so as all level 2 measures of the AIFMD are mandatory, not optional.

A **comparison of the options** against a 'do nothing' was not possible as there is no clear-cut baseline. As explained above, it is not trivial to define an appropriate baseline for these level 2 measures as they, on the one hand, address an area which has not been regulated at Union level so far, in parts not even at national level, but on the other hand will be affected by the impacts of the level 1 Directive anyway. It is also almost impossible to construct such a baseline in a meaningful way that would allow quantifying impacts because of the differences in current practices on the one hand and in the ways the AIFMD would be transposed if no level 2 measures were adopted. It will, however, nevertheless be used as counterfactual in order to assess the impacts of the options discussed.

To **improve the presentation**, the report has been shortened in some parts. Furthermore, the impact analysis sections have been amended with indications as to how the preferred options in this IA deviate from the technical advice by ESMA.

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[9] See the Study on "The retailisation of non-harmonised investment funds in the European Union", Study on "investment funds in the European Union: comparative analysis of use of investment powers, investment outcomes and related risk features in both UCITS and non-harmonised markets [http://ec.europa.eu/internal_market/investment/studies_en.htm] and Report by the Expert Group on Open Ended Real Estate Funds [http://ec.europa.eu/internal_market/investment/real_estate_funds_en.htm], Reports of the Expert Group on Alternative Investment Funds [http://ec.europa.eu/internal_market/investment/alternative_investments_en.htm#alternative].

3. PROBLEM DESCRIPTION

3.1. Problems identified in the level 1 impact assessment

When considering the proposal for the level 1 Directive in spring 2009, the following six problem areas had been discussed:

1. Macro-prudential (systemic) risks: The absence of a consistent approach to the collection of macro-prudential data (e.g., on leverage or risk concentrations) and of effective mechanisms for the sharing of this information between prudential authorities at the European or global level is a significant barrier to robust macro-prudential oversight. Existing arrangements do not take sufficient account of the cross-border nature of risks arising in the AIFM sector.

2. Micro-prudential risks:[10] AIFM in the EU are not currently subject to consistent requirements as regards their risk management procedures and processes. Weaknesses in risk management practice present risks for investors, counterparties and the market at large. Greater consistency in regulatory standards in this area would provide greater assurance for domestic and cross-border investors and counterparties and reduce opportunities for regulatory arbitrage.

3. Investor protection: Although the majority of investors in AIF are professional investors, the financial crisis has demonstrated that even this category of investors requires reliable and comprehensive information. National regulatory approaches to disclosure practice and governance vary and do not provide a consistent regulatory framework for AIFMs. .

4. Market efficiency: AIFM activity may impact not only on financial stability but also on the efficiency and integrity of the markets in which they operate, irrespective of the location of those markets.

Issues 5. Impact on market for corporate control and 6. Acquisition of control of companies by AIFM are not discussed in this document as there are no level 2 measures directly addressed to these issues.

All of these problems still exist. While with the creation of ESMA and the European Systemic Risk Board (ESRB) the necessary infrastructure bodies for improved macro-prudential supervision has been established, these entities still require a legal basis on which their data and information needs can be satisfied.

3.2. Scope of the issues addressed in the Level 2 impact assessment

The ability of the AIFMD to reach its intended policy goals will depend on a few crucial choices that are made in relation to certain core matters to be addressed at level 2. This impact

[10] It is important to distinguish the different approaches or 'forms' of risk discussed in this impact assessment. The distinction between macro- and micro-prudential risks is relevant as the latter are primarily in the focus of fund managers and investors as they would be the (most) impacted by them while macro-risks would arguably impact a wider range of actors, presumably including tax payers if governments have to step in in order to avoid a collapse of the financial system as in the Lehman crisis. These risks are to some extent external to the fund manager and their investors as they might not have to pay for the damage. In addition to these two risks there are several other forms of risks which are linked to the investments of a fund such as market risk, counterparty risk or liquidity risks which are the subject of the risk management of AIFM. For more detail see Annex 3.

assessment has identified eight such matters in five domains. Choices at level 2 in relation to these issues will have a decisive impact on the overall ability of the AIFMD to meet its stated objectives in an efficient manner.

Issue	Level 2 empowerment	Content
Issue 1:	Article 3 (6): Exemptions	The method of calculating the AIFM's assets under management is key in defining the AIFMD's scope
Issue 2:	Article 4 (3): Definitions	The method of how *leverage* is to be calculated is important for an early identification of systemic risk. Leverage is a key concept of the AIFMD: information on the extent to which an AIFM engages in leverage is crucial for investors and supervisors; this information should be comparable across Member States and AIF; certain reporting obligations depend on whether the AIFM uses leverage on a substantial basis.
Issue 3:	Article 9 (9): Additional own funds	The requirement of additional own funds or of a professional indemnity insurance (PII) that covers professional liability risk has implications for the level of investor protection and market efficiency achieved by the AIFMD.
Issue 4:	Article 21 (17): Depositary	The perimeter of financial instruments that can be registered in a depositary's financial instruments account determines the scope of the latter's obligation to return instruments lost in custody.
Issue 5:	Article 21 (17): Depositary	The scope of liability for losses that occur while an instrument is held in custody determines the level of investor protection.
Issue 6:	Article 21 (17): Depositary	The precise scope of *cash monitoring* is important for investor protection.
Issue 7:	Article 24 (6): Reporting to competent authorities	Reporting frequencies are decisive in achieving adequate monitoring of systemic macro- and micro-prudential risk and an adequate level of investor protection.
Issue 8:	Article 24 (6): Reporting to competent authorities	The issue of when *leverage* is to be considered to be *employed on a substantial basis* is crucial in triggering the reporting obligations in Article 24(4) AIFMD.

Annex 7 assesses those implementing measures, for which no detailed IA has been conducted, providing a short description of the respective issues, the implementing measure and, in a nutshell, a brief consideration of possible options and their likely impacts.[11]

This chapter provides an overview of the overall problems to be addressed and objectives to be achieved in keeping with the level 1 Directive. A more detailed discussion with respect to the individual implementing measures follows in the succeeding sections.

3.3. Problems identified in the level 2 impact assessment

3.3.1. Issue 1: Calculation of the assets under management (AuM)

The exemptions provided in Article 3 AIFMD for AIFM below the threshold can be linked, directly or indirectly, to all the risks identified at level 1, the exemptions seek to balance these risks with the costs and the appropriateness of addressing them in the AIFMD for the AIFM concerned.

The risk identified at level 2 is that without further specification of the method for calculating the total value of assets under management (AuM) this calculation could be done differently by different AIFMs. Indeed, inappropriate calculation methods could lead to a circumvention

[11] A complete list of all implementing measures can be found in Annex 4.

of the full set of requirements of the Directive by understating AuM. The result would be uncertainty about the achievement of the objectives of regulation and appropriate prudential supervision of all actors in financial markets (G20 commitment) and of appropriate investor protection.

3.3.2. Issue 2: Calculation of leverage

The AIFMD provides a definition of leverage in order to ensure that the effect of leverage is properly taken into account in the activities of AIFM and their supervision.

Leverage not only magnifies the impact of risks for investors, but also can mean that leveraged AIF have a much stronger influence on markets than otherwise expected, that can ultimately create systemic risks. That is why the treatment of leverage under the AIFMD is important for investor protection, macro-prudential risk control and market efficiency and integrity.

However, a high level definition of leverage as contained at level 1 does not ensure that leverage is calculated in a harmonised way by AIFM. The population of AIFs is extremely heterogeneous; different AIFs invest in all kinds of asset classes, from equities and bonds to real estate or commodities such as gold or oil. Their investment strategies can vary from the simple replication of an index of stocks to the most complex investment strategies with extensive use of derivatives. In this regard, they may use a multitude of different kinds of derivatives or borrow money in order to increase the exposure of the AIF.[12]

In view of this diversity it is not surprising that AIFM currently also use a multitude of methods to calculate leverage in their AIF. Even if the definition of leverage in the AIFMD would lead to a certain narrowing of this diversity, it would still permit very different approaches with very different results.

Therefore, in the absence of further measures specifying the calculation of leverage, the risks that the level 1 Directive tries to address would hardly be lessened. Leverage figures reported by AIFM could still not be compared. This would make it difficult if not impossible for investors to compare and assess the risk profiles of AIF and for supervisors to monitor funds and markets effectively.

3.3.3. Issue 3: Additional own funds

The AIFMD requires AIFM to hold appropriate additional own funds or professional indemnity insurance (PII) to cover potential liability risks arising from professional negligence. This aims at reducing the risk to investors that professional negligence at the AIFM could have an adverse impact on the performance of the AIF managed by this AIFM; for example, because investments cannot be made or assets cannot be sold as the AIFM cannot maintain its operational capacities.

Without further specifying the appropriateness of such additional own funds or PII there would be a risk that some AIFM hold insufficient coverage to ensure investor protection. The proper definition of the appropriate conditions is also important in order to avoid regulatory arbitrage. Inconsistencies in the application of capital requirements could incentivise AIFM to locate in Member States with lower requirements and investors would have difficulties to

[12] The concept of exposure of an AIF is described in Annex 5.

assess the degree of protection in case of damage caused through the AIFM's professional negligence.

3.3.4. Issues 4-6: Depositary

Issue 4: Scope of custody

Although the AIFMD, in Article 21(8), provides some guidance as to the assets that can be held in custody, Article 21(8) does not provide a list of types of financial instruments[13] that can be registered on an account opened in the depositary's books. The elaboration of a typology of financial instruments was left to delegated acts to be adopted by the Commission pursuant to Article 21(17)(c)(i). The typology has to be uniform and apply across all jurisdictions across the European Union. The lack of a common stance on which financial instruments are to be held in custody creates the risk that different interpretations on the scope of custody emerge among different national laws and regulations that transpose the AIFMD. This could lead to differences in the scope of depositary's liability to return the assets that are lost in custody. The Madoff fraud[14] has demonstrated that investors' claims for compensation for assets lost in custody are not addressed in the same manner in different Member States.

In its advice on defining the precise scope of custody, ESMA has determined that financial instruments belonging to an AIF such as transferable securities, money market instruments and units of collective investment undertakings should be held in custody. In its final report, ESMA however does not entirely address all matters that need to be clarified in relation to 'listed derivatives'.[15]

Issue 5: Definition of an "external event"

Clarity as to the assets that are to be held in custody are one of the most important ingredients in ensuring that one of the objectives of the AIFMD, enhancement of investor protection, is attained. Therefore, Article 21 (12) AIFMD provides for a broad liability for depositaries – that is making a depositary liable in case of loss of the financial instruments held in its custody or in the custody of a sub-custodian appointed by the depositary pursuant to Article 21(11) AIFMD. To exonerate itself from the liability to restitute the lost assets, the depositary must demonstrate that the loss was a result of "an external event beyond reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary".

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[13] AIFMD defines financial instruments by reference to the list in Annex I, Section C of MiFID.

[14] The management of the […] fund (a UCITS compliant fund) was delegated by its management company, [….] to Bernard Madoff's investment company. The safekeeping duties were delegated to a US broker (Bernard Madoff Investment Securities). In December 2008 the Madoff fraud was uncovered and […] incurred significant asset losses. In subsequent law suits, various EU jurisdictions have assessed the liability of the depositary in different ways.

[15] Listed derivatives, as opposed to the so called over-the-counter derivatives, can be understood as those standardised derivatives that are admitted to trading on a regulated market as defined by MiFID and are cleared and settled centrally by Central Counterparties (CCP). Listed derivatives are, however, financial instruments within the scope of Annex I of MiFID. In their regard, ESMA refrains from providing conclusive advice, invoking the fact that future legislation in relation to securities (forthcoming proposal on Securities Law Directive - SLD) and in relation to the types of derivatives that will be cleared via central counterparties (EMIR) are pending. In these circumstances, ESMA believes that no definite advice can be provided as to whether various types of derivatives are to be within the scope of custody or not. This issue might need to be revisited once the SLD and EMIR are adopted. The entry into force of the SLD and EMIR might entail that current custodial practice in dealing with these instruments will need to be assessed.

The definition of what constitutes such an "external event" is thus of crucial importance for the effectiveness of the AIFMD's provisions on depositaries and their liability. The aim of the AIFMD, to provide a uniform level of investor protection in case an asset in custody is lost, would not be achieved if different national authorities and courts would interpret this core notion in different ways.

Furthermore, according to Article 21(11), a depositary may, under certain conditions, delegate its safekeeping's duties to a third party. The impact of delegations between the depositary and its sub-custodian on the depositary's liability is further clarified by Article 21(12) which provides that "the depositary's liability shall not be affected by any delegation". Again, if different jurisdictions were to interpret the consequences of a delegation to a sub-custodian in different manners, the aim of providing a uniform level of protection would not be met.

Issue 6: Scope of cash monitoring

In the case of a loss or misuse of an AIF's cash including from subscriptions to AIF units by investors, another important area arises where significant possible damages to investors might occur. The depositary duty to ensure that an AIF’s cash flows are properly monitored and that payments made upon subscription of AIF' units have been received is therefore a key investor protection safeguard. While Article 21(7) provides for the above mentioned general requirements, it is left to delegated acts to further specify the depositary's duties relating to monitoring the AIF's cash flows.

Materially different degrees of intensity of monitoring of AIF’s cash flows could lead to inconsistencies in or inappropriateness of depositary monitoring efforts to the detriment of investors.

3.3.5. Issue 7: Reporting to competent authorities

The financial crisis has highlighted that supervisors did not always have all the necessary information at their disposal or could not get information quickly enough to properly assess the situation and to take emergency action. This issue relates to a number of the problems identified at Level 1: there was insufficient control of macro-prudential (systemic) risks and of risks to market efficiency and integrity; investor protection could not be ensured without sufficient information provided to supervisors. In addition, without sufficient information, supervisors might not be in the position to oversee whether AIFM properly address micro-prudential risks, e.g. with regard to risk and liquidity management.

While Article 24 AIFMD already prescribes certain elements on which AIFM will have to provide information, it does not prescribe the frequency of reporting. Without the level 2 measure there would be a risk that supervisors might (still) not get all the appropriate information they need or might not get it in the appropriate form and at the appropriate moment with impacts with regard to macro-prudential oversight, market efficiency and integrity and investor protection.

3.3.6. Issue 8: Leverage employed on a substantial basis

As pointed out above, leveraged AIF might have strong impacts on markets in which they are active and might even pose systemic risks. Therefore, Article 24(4) AIFMD requires AIFM managing AIFs employing leverage on a substantial basis to report certain information related to leverage for each AIF they manage.[16] The specification of when leverage is considered to be employed on a substantial basis is important in ensuring the effective and uniform application of these additional reporting requirements.

Information on leverage are essential for competent authorities to identify and monitor systemic risk, risks of disorderly markets or risks to the long-term growth of the economy according to Article 25 AIFMD. Article 25 also empowers competent authorities, based on their monitoring of systemic risk, to impose leverage limits on the AIFM. Inadequate reporting on leverage would therefore hamper the macro-prudential supervision carried out by the competent authorities across the EU. Unclear specification of the substantial level of leverage would result in legal uncertainty for the AIFM as to their reporting obligations and could lead to market inefficiencies. As mentioned in section 3.3.5, investor protection could not be ensured without sufficient information provided to supervisors.

3.3.7. How would the problem evolve without action?

As this area has not been regulated at Union level so far, in parts not even at national level, but hand will be affected by the impacts of the level 1 Directive anyway, even if there were no level 2 measures, it is difficult, how the problems would evolve without the level 2 measures. The more so as the level 1 Directive provides Member States with some flexibility in the transposition and implementation.

In considering the evolution of identified issues in the absence of action at the European level, it is therefore important to remember that the Commission is required to act by level 1. It is not possible to consider a base-line of 'no action', as the positions taken at level 1 have already presupposed the adoption of level 2 measures at the European level: strictly speaking, there cannot be a situation in which the problem evolves without further action at the European level, and level 1 and level 2 cannot be separated.

The level 2 empowerments in the AIFMD require the specification in greater detail of certain elements of the respective level 1 provisions. The reason behind these empowerments is generally that the co-regulators saw a risk that without further specification provisions could be implemented differently across the Union, either directly in the national implementing laws, via interpretation by supervisors or the fund industry.

More specifically, such differences could result in:

- legal uncertainty for AIFM, depositaries, investors and other stakeholders
- a non-level playing field for AIFM across Member States
- a lower, or at least less certain, level of investor protection
- greater micro- and macro-prudential risks as cross-border supervision would not be fully effective

In short, a lack of detailed specification of requirements in the areas identified would put in question the achievements of the objectives of the AIFMD, leaving the EU with greater risks,

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[16] The information to be reported includes the overall level of leverage, the break-down of the methods of leverage, the extent of reuse of AIF's assets by their counterparties and the identity of the five largest sources of borrowed cash and securities.

a less efficient AIF market and a lower level of protection of and choice for professional investors. A more detailed description as to how problems might evolve with regard to the individual level 2 issues can be found in Annex 8.

4. THE EU'S RIGHT TO ACT AND JUSTIFICATION

The European Commission's and the EU's right to act is discussed in the impact assessment which accompanied the AIFM Directive 2011/61/EU. In summary, the AIFMD aims to provide a clear and consistent framework for the regulation and supervision of AIFM in the EU, it establishes at European level a mechanism for creating a single European market for alternative investment funds in line with the legal base underpinning Community legislation in this area (Article 53(1) TFEU).

The legal basis for action at level 2 is provided (and delimited) by the power of the Commission to adopt delegated acts and implementing measures in Chapter X of the Directive. The Directive requires delegated acts and implementing measures to be adopted in specified areas in order to ensure that the regime is implemented in a consistent way across the EU.

The analysis of concrete options for the provisions of the level 2 measures will consider the precise nature and extent to which harmonisation is necessary, always with the principle of subsidiarity in view. However, action solely at Member State level would not be able to effectively or efficiently address these issues, given the centrality of the single market and the cross-border dimension of the AIFM sector. Action solely at Member State level would run the risk of erecting or maintaining barriers to further integration and efficiency of managing and marketing AIF in the EU, thereby potentially raising costs and risks for investors, whilst also increasing costs.

5. OBJECTIVES

The overarching objective of the AIFM Directive is to provide a clear and consistent framework for the regulation and supervision of AIFM in the EU. This objective is not only consistent with the G20 appeal for appropriate regulatory and supervisory arrangements to apply to all systemically relevant market actors, and with the conclusions of the European Council's 2009 Spring Summit, but goes further in providing at the same time the necessary legislative framework for a single market for AIFM and establishing a high level of investor protection in the Union.

The more specific objectives of the Directive can be summarised as follows:

- Supervision of players in financial markets: Appropriate authorisation and registration of AIFM and on-going supervision
- Systemic risk oversight: Improved monitoring of macro-prudential risks by competent authorities (CA)
- Risk management: Enhanced management of micro-prudential risks in AIF by AIFM
- Investor protection: A common approach to protecting investors in AIF
- Transparency: Greater public accountability of AIFM investing in and managing companies

- <u>Market efficiency</u>: Removal of barriers to the efficient cross-border distribution and management of AIF

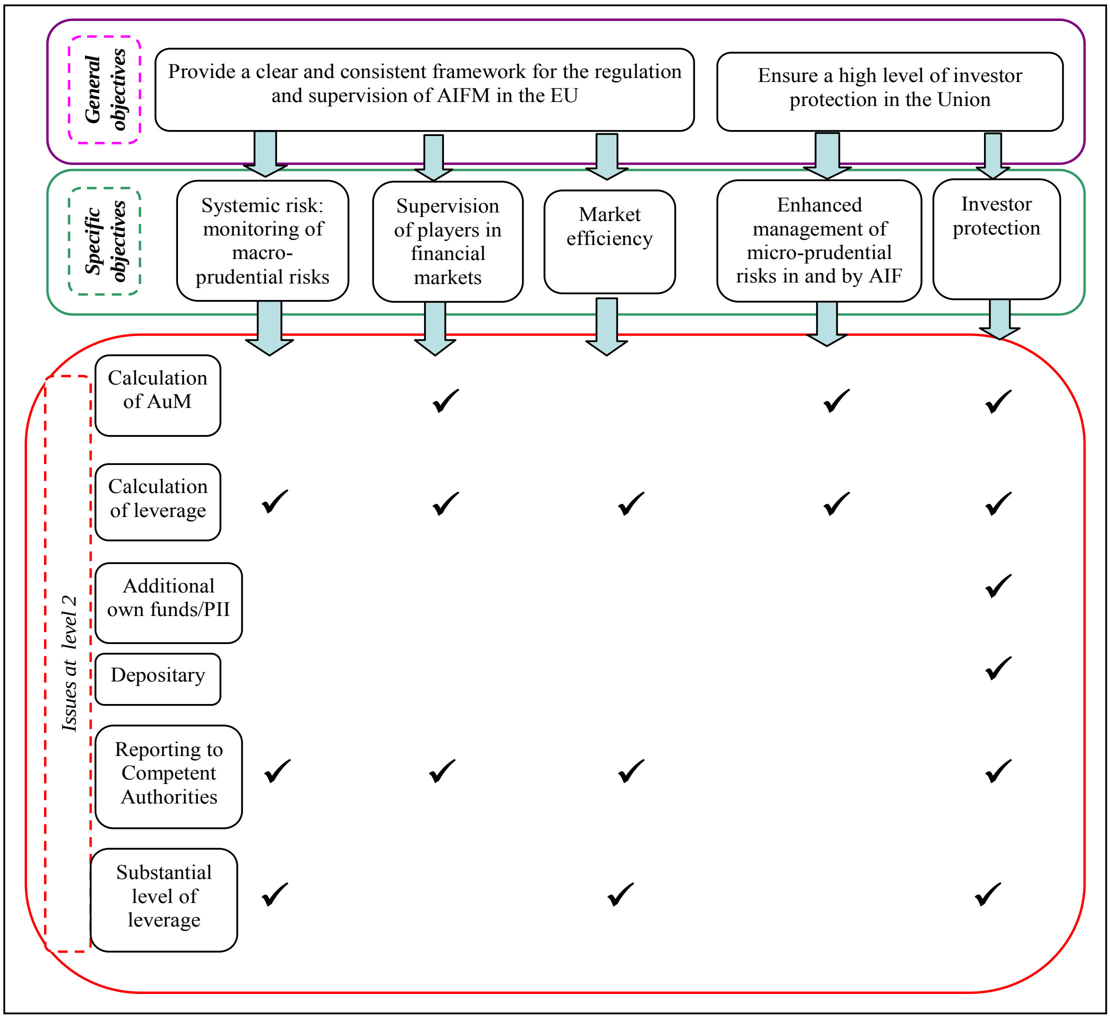
With respect to the implementing measures, <u>additional operational objectives</u>, which derive from the above can be defined:

- Issue 1, <u>Calculation of the AuM</u>: Develop a harmonised approach across MS and AIFMs for the calculation of AuM to prevent regulatory arbitrage, ineffective supervision and to ensure investor protection.
- Issue 2, <u>Calculation of leverage</u>: Ensure the production of reliable figures that are a proper reflection of the exposure of an AIF and comparable across (similar types of) AIFs
- Issue 3, <u>Additional own funds/PII</u>: Ensure that AIFM hold sufficient own funds or PII coverage for operational risks to improve/ensure investor protection, to indirectly reduce micro-prudential risks and improve market integration.
- Issues 4-6, <u>Depositary</u>: Ensure that investor protection safeguards within the depositary regime are not weakened, circumvented or applied materially differently due to variations in rules between different Member States; in particular, ensure a uniform approach to definition of financial instruments subject to custody, that detailed measures on the depositary are specified in such way that custody obligations and liabilities are not weakened or undermined through delegation arrangements or contractual clauses reducing the depositary's liability and that cash flows are properly monitored by the depositary.
- Issue 7, <u>Reporting to Competent Authorities</u>: provide supervisors with relevant information with the appropriate level of detail and uniformity so as to allow it to be disseminated and aggregated in a timely manner, without imposing undue burden on AIFM. The reporting frequency should be balanced between the need for competent authorities to prevent systemic risk and the avoidance of excessive administrative burden for authorities and AIFMs.
- Issue 8, <u>Leverage employed on a substantial basis</u>: Ensure adequate and uniform reporting of leverage information to the competent authorities. The reporting should balance the need for competent authorities to prevent systemic risk with the avoidance of excessive administrative burden for authorities and AIFM.

These operational objectives on substance are in all cases accompanied by the objective to keep the administrative burden for AIFM, competent authorities and other parties that might be concerned as low as is consistent with achieving the objectives sought not least because most of these costs might fall back on investors in the form of reduced returns.

The chart below gives an overview of the 'hierarchy' of objectives across the level 1 and level 2 impact assessments. For the level 2 objectives it focuses on the main links to the specific objectives.

Chart 1: Objectives of the AIFM Directive addressed by the level 2 measures discussed in this IA



The tables summarising the problems addressed, the drivers behind them and the objectives of the level 1 and level 2 impact assessments for each of the issues addressed in this impact assessment can be found in the Annex 9. This Annex also discusses the link between this initiative and the parallel initiatives on venture capital funds and social investment funds.

6. ANALYSIS AND COMPARISONS OF OPTIONS

6.1. Baseline scenario

As already discussed the AIFMD often does not leave much scope for choice over how to specify measures. In addition, all level 2 measures of the AIFMD are mandatory, not optional. Therefore, the baseline option of 'do nothing' or 'no action' is not a valid option. It will, however, nevertheless be used as counterfactual as this helps clarify the impact of the options at level 2.

6.2. Issue 1: Calculation of total assets under management

Before developing and discussing options regarding the 'calculation of the total assets under management', it is important to stress the difference between this calculation and the valuation of assets.

Valuation methods will vary according to the type of assets. Most assets are currently valued 'mark to market'; which means that the AIF uses the current market value of the asset in its book records. This is, for example, the case for equity shares, bonds or financial derivative instruments (FDI). The valuation of other assets such as real estate or non-listed companies may follow different methods. Once the values of all assets have been established, the AIFM will be able to calculate the total value of the assets under its management.

Article 19 of the Directive determines how the individual assets of AIF have to be valued. It makes clear that such methods "shall be laid down in the law of the country where the AIF is established and/or in the AIF rules or instrument of incorporation".[17] Article 19 focuses on what has to be done and who would be eligible to do it, i.e. organisational and procedural issues. It can therefore be concluded that the valuation of assets for the calculation of the total assets under management should be done in the same way.

The focus of the delegated act is on the calculation, in contrast, of the total AuM; on what has to be taken into account for the calculation and how.

The distinctive features of the different options for this are therefore:

- who (EU level, national law, CA, AIFM) determines what has to be taken into account;
- if this is done at EU level: what has to be taken into account (only net assets, all assets, possible exemptions, derivatives or underlyings, etc.)

On this basis, four options can be defined:

<u>Option 1 (no action)</u>: No action is not a viable alternative because there is a legal obligation for the Commission to adopt level 2 measures.

<u>Option 2 (NAV)</u>: It is determined at EU level that the calculation has to be done on the basis of the Net Asset Value (NAV). The NAV is equal to the total equity value of an AIF, i.e. the fund's assets minus its liabilities. Like companies, AIF have to follow national accounting requirements, e.g. producing a balance sheet, and the basic accounting equation holds: assets equal the sum of liabilities and equity. What is called net equity or net assets in the corporate universe is called NAV in the fund universe. It represents the value that remains for the investors after all positions have been liquidated and all other liabilities been paid. The NAV is a crucial figure in the assessment of AIF as it is the basis for many performance ratios etc.

<u>Option 3 (Total AuM using market value of FDI)</u>: The calculation rules are determined at EU level. The calculation includes the value of all assets under management (AuM) by the AIF without deducting the liabilities. This deviation from the NAV approach is motivated by the fact that the AIFMD stresses that total assets should be taken into account, including those acquired through borrowing. Financial derivative instruments (FDI) are valued at their market price or at costs.[18]

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[17] It had been discussed intensively at level 1 whether or not valuation rules should be left to national law or not. However, the costs of implementing an entire new valuation system for AIF have been regarded as much higher than the benefit of having a uniform valuation system.

[18] FDIs are instruments whose prices or values depend on prices of underlying assets like stocks, bonds or interest rates. They permit, with a lower invested amount, to gain an exposure to the underlying asset equivalent to an exposure resulting from a direct investment. FDIs can represent the majority of the AIF

Option 4 (Total AuM using underlying exposure of FDI): Option 4 goes a step further in prescribing a specific approach to the valuation of FDIs. This is again motivated by the wording of the definition of assets under management in Article 3(2)(a) AIFMD as including assets acquired through the use of leverage. To calculate value of assets acquired through the use of leverage, including leverage embedded in derivatives, it is necessary to define a common set of valuation rules aiming at capturing the true exposure of these instruments, therefore not relying on the practice of using the market value of the FDI itself as described above.

The calculation includes the value of all assets held by the AIF without deducting the liabilities. In contrast to option 3, FDIs are valued at their equivalent position in the underlying assets, not at their market value. The level 2 measures regarding the leverage calculation (see below) define how this conversion has to be done. This value represents the amount the AIF would have needed to invest directly in the underlying asset to gain an equivalent exposure as the one created by the FDI.

Box 1: Valuation of a FDI on mark-to-market basis and on the value of the underlying

Call options giving exposure to the DAX index worth €1 million could be equivalent to a direct investment of €15 million in the DAX index. In this case, when the value of the underlying was used as a basis, the AuM of the fund were not €1 million but €15 million. Detailed examples of other FDIs are listed in the leverage section.

Analysis of impacts

Option 2 (NAV): Although convenient and relatively cheap for AIFM, the use of NAV would run against the letter of Article (3)(2) of the Directive which explicitly refers to "assets under management, including any assets acquired through the use of leverage, in total…". As the NAV equals assets minus liabilities, it does not respect the requirement to include the assets in total. It might lead to the exemption of AIFM of AIF with high liabilities which arguably might pose greater risks and therefore require closer supervision than others.

The NAV is disclosed in any marketing documentation and is updated on a regular basis, from a daily basis for certain open-ended funds to an annual basis for certain closed-ended funds. Prima facie, this availability and the familiarity of AIFM, investors and supervisors with the concept of NAV would be, besides the low costs, advantages supporting this option.

Option 3 (Total AuM using market value of FDI): Compared to option 2 this option would increase the number of AIFM falling under the full scope of the Directive significantly. It would thereby better contribute to the achievement of the objectives as AIFM below the threshold are only supervised with regard to systemic risk monitoring.[19] This option would not increase costs for AIFM as they have to calculate the value of all assets anyway for the NAV calculation.

Option 4 (Total AuM using value of underlying exposure of FDI): This option would result in higher values of total AuM than options 2 and 3 for AIFs using FDIs. Thus, more AIFM of leveraged AIF would fall under the full scope of the Directive. As described in Box 1, exposure of AIF through leverage considerably extends the potential impact or "footprint" of

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exposure while accounting only for a small percentage of AIF assets. Annex 13 provides an example of the total asset calculation for a derivative.

[19] However, as discussed in the level 1 IA report, a greater degree of the achievements of objectives has to be weighed against the related costs.

AIF on both markets and investors beyond the value of the assets themselves. Therefore, it is important to take the use of leverage fully into account in the calculation of the threshold. It would have the important benefit of leading to the same result for an AIF invested directly in, say, a certain share, and an AIF investing in an FDI on that share. This would ensure that the scope of the AIFMD as set out in level 1 is ensured also for AIFM managing leveraged AIF and that such AIFM cannot circumvent full regulation and would eliminate perverse incentives to invest precisely in arguably riskier FDI in order to avoid full regulation. In short, this would also lead to greater regulatory fairness across AIFM.

This option, however, would lead to additional costs for AIFM making use of FDIs as they would have to calculate the values of 'equivalent positions', an operation that is not common practice at the moment. The exact amount of the costs would depend on the type of FDI. While it would probably be rather low for many of them, it might entail particular costs in other, more exotic, cases and might require frequent adjustments. In turn, however, these AIFM should have the necessary tools at hand to do this kind of calculation. In the beginning, this option could confuse investors if AuM of AIF would suddenly appear to be much higher than before under the NAV calculation. Yet, as the AIFMD regulates marketing to professional investors only, it should not be very burdensome for AIFM to explain this new approach and not too difficult for professional investors to understand it.

Impacts on stakeholders

A uniform approach to the calculation of total AuM will ensure a consistent approach to whether AIFM are to be seen as above the threshold, and that those that should be subject to the regulations designed for those above the threshold are uniformly so subject. This will benefit investors and all citizens as relevant AIFM would be under appropriate micro- and macro-prudential supervision. The costs involved in the calculation of the total AuM would fall on the AIFM, but will most likely be rolled over to on investors. The costs of setting up and using the methods under option 4 would be somewhat higher than for the other options for AIFM making use of derivatives. But these higher costs for AIFM and investors are justified by the fact that this method would ensure that those AIFM that arguably present greater risks for markets are under appropriate supervision.

The impacts of the different options for AIFM vary primarily according to the extent to which they invest in FDI. For AIFM who do not invest in FDI or only to limited extent there is no (major) difference between options 3 and 4, while for 'heavy users' of FDI, the results of the results of calculations of AuM under options 3 and 4 would differ significantly, the one of option 4 being a multiple of the one of option 3. The costs would mainly be one-off as the calculations could in general be automated. Strictly speaking, additional costs would only arise for AIFM below the threshold as those above would in any case have to do these calculations for the calculation of their leverage figures (see section 6.3 below).

Comparison of options

In their responses to the public consultation on the draft advice by ESMA, AIFMs did not have uniform views on this issue. While some argued that the NAV (option 2) would be an appropriate method, others argued that NAV would not work for all types of AIF. Overall, they argued for a differentiated approach taking into account the diversity of AIF (potentially option 1).

The calculation methods of options 3 and 4 offer a more comprehensive view of the exposures of AIF/AIFM because liabilities are not deducted. The main drawback of option 3 in comparison to option 4 is its limitation regarding the value of FDIs. Option 3 would not take the leverage embedded in FDIs fully into account and a regular mark-to-market value of the derivative would underestimate the true exposure associated with such instruments.

From a cost perspective, option 4 would impact AIFM using FDIs slightly more than the other options. The market value of the FDIs is in most cases directly accessible but the exposure created by FDIs might necessitate one-off costs to adapt the IT systems and educate staff on the correct valuation of FDI. The option would most likely result in higher operating costs notably for collecting the necessary information to calculate the exposure embedded in FDIs. These costs have however to be contrasted with the costs associated to the calculation of leverage under the gross method (see option 3 in the next section) which requires the same methodology for FDI. Therefore these higher costs will in any case be incurred by all AIFM above the threshold using FDIs.

In the table below, options are weighed against two fundamental criteria: their effectiveness in achieving the Level 1 objectives and their efficiency in terms of achieving these objectives for a given level of resources and costs. The results of the comparison are rated according to the following scale: "+" slightly positive, "++" positive, "-" negative, "--" very negative, "≈" neutral. The benchmark is the implementation of the AIFMD without the implementing measure in question. In this case, one could argue that it would be pretty close to option 1 as option 1 would not provide much more than some general guidance or 'high level principles' to national regulators. It differs, however, in one crucial way from the benchmark: depending on the choice of Member States, AIFMs would most likely have to adjust and to bear costs. As option 2 (NAV) is rather standard for most types of AIF/AIFM, no major impacts compared to the status quo were to be expected.

Table 3: Calculation of total assets under management - comparison of options

	Effectiveness			Efficiency
	Macro- prudential supervision	Micro-prudential supervision	Investor protection	Limiting administrative burden
Option 1: No action	0	0	0	0
Option 2: NAV	-	-	-	+
Option 3: Total AuM using market value of FDIs	+	+	+	+
Option 4: Total AuM using underlying exposure of FDIs	++	++	++	-

Based on the discussion above and the assessment on the basis of the table above, options 3 and 4 have clear advantages over options 1 and 2. The comparison between options 3 and 4 hinges mainly on the trade-off between costs and achievement of objectives as option 4 rates higher in both categories. All in all, however, the equal treatment of AIF using derivatives extensively and those who do not and the avoidance of incentives for the greater use of derivatives under option 4 is the preferred option. This choice is further supported by the advice by ESMA which also favours this option.

ESMA identifies potential increases in costs for small AIFs investing extensively in FDIs because they might be obliged to follow the AIFMD regime which would not have been the case under the other options. Yet, such costs can also be assessed against the benefits bestowed by the Directive, in particular the "EU passport".

6.3. Issue 2: Calculation of leverage

Leverage is a core concept in the AIFMD because some important provisions of the Directive differentiate between leveraged and unleveraged AIFs. Four areas are concerned: scope of application, systemic risk oversight, disclosures to investors and reporting requirements. The Directive does not apply in full to AIF which have no redemption rights exercisable during a period of five years following the date of initial investment and have Assets under Management (AuM) below €500 million as long as the AIF is unleveraged whereas the threshold regarding AuM is decreased to €100 million when the AIF acquired exposure to certain underlying assets through the use of leverage.

The level of leverage is also used by competent authorities to identify "the extent to which the use of leverage contributes to the build-up of systemic risk in the financial system, risks of disorderly markets or risks to the long term growth of the economy" (Article 25(1)). Competent authorities are empowered to force the AIFM to reduce leverage if they are of the view that it represents a threat for the financial system. Furthermore, the AIFMD puts additional reporting obligations to competent authorities on managers of substantially leveraged AIFs (see section 6.8). The use of leverage will also have to be disclosed regularly to investors.

It can be expected that information about the use of leverage will be crucial information for both competent authorities and investors. In order to allow investors to compare such information across AIF and across borders in the Union when taking investment decisions, and to provide supervisors with information that is comparable and can be aggregated for the purpose of macro-prudential and systemic risk oversight, a harmonised approach to the calculation of leverage is crucial.

The AIFMD defines 'leverage' as "any method by which the AIFM increases the exposure of an AIF it manages whether through borrowing of cash or securities, or leverage embedded in derivative positions or by any other means". Exposure is a different concept than AuM discussed in the previous section. While AuM adds up the value of all assets, exposure focuses on the value of fund assets which is exposed to, for example, market risk or credit risk.[20]

Leverage of an AIF will be expressed as the ratio between the AIF's exposure and its NAV:

$$\boxed{\text{Leverage:} = \frac{\text{Exposure}}{\text{NAV}}}$$

With the exception of option 2, which aims to be a direct measurement of leverage, the options below represent different approaches to determine the exposure of an AIF.

Option 1 (no action): No action is not a viable alternative given the legal obligation for the Commission to adopt harmonising level 2 measures.

Option 2 (VaR): Value at Risk (VaR) is a widely used and well-known measure of the maximum potential loss at a given confidence level (probability) over a specific time period under normal market conditions. The relative VaR approach, developed initially by CESR for

[20] Some assets, such as cash in the base currency of an AIF, are not regarded as creating any exposure.

UCITS,[21] is a method that would compare the VaR of the AIF with the VaR of an unleveraged reference portfolio. The resulting ratio would be considered as the leverage of the fund.

<u>Option 3 (Gross method):</u> The exposure of an AIF calculated in accordance with the gross method is the sum of the absolute value of all positions, i.e. all assets purchased plus the absolute value of all liabilities, valued in accordance with Article 19 of the Directive. Article 19 prescribes that the value of assets shall be calculated according to the law of the country where the AIF is established. Except for special assets still valued according to national accounting standards, most of the assets are valued across Europe in the same way ("mark-to-market"). Based on this basic methodology, some exceptions need to be pointed out.

Derivatives have to be converted into an equivalent position in the underlying asset. That is, not at the market value of the derivative but at the market value of the asset the AIF could potentially buy or sell with this derivative.[22]

<u>Option 4 (Commitment method):</u> The so-called commitment method is the second method that CESR has developed for UCITS. In principle, derivatives, cash and borrowings are treated as under the gross method. The commitment method allows, however, certain investment positions to be excluded from the calculation if these aim at offsetting some risk such as 'netting' and 'hedging' arrangements.

Both arrangements are combinations of trades on derivatives or securities which are concluded with the sole aim of offsetting the exposure linked to other positions, thereby allowing AIFMs to reduce overall exposure of their AIFs. Netting arrangements should "eliminate" the risks whereas hedging arrangements should "offset" risks linked to positions. This means that hedging positions need not necessarily hedge 100% of a particular position but should nevertheless be effective. Furthermore, netting arrangements must be related to the same underlying asset whereas hedging arrangements must relate to the same asset class.

The motivation behind this is that while making use of instruments, which in principle increase the exposure of an AIF, effective hedging or netting arrangements lead in fact to a decrease in the overall risk in the fund. If an AIF that is invested in a certain share buys an option on this share that would allow the fund to sell the share at a fixed price, the 'exposure', the potential loss of the AIF is limited to the difference between the price at which it had bought the share and the price at which it could sell it again. Without this option the AIF could potentially lose 100% of its investment if the company went bankrupt as in the example above. – In simple words, the commitment method distinguishes between leverage that potentially increases risk and leverage that reduces risk and takes only the former into account in the calculation of the leverage of the fund.

<u>Option 5 (2 methods)</u>: As the methods outlined above have some shortcomings, AIFMs would have to calculate leverage on the basis of a combination of options 3 and 4.

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21 CESR Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (CESR/10-788)

22 Cash and cash equivalents can be excluded to the extent that they respect some criteria, e.g. if they carry no market risk, have a remaining life time of less than 3 months and a yield which does not exceed the yield of high quality government bonds. Borrowings can also be excluded if they are stable in nature (e.g. bank loans) and as long as reinvestments realized with these borrowings are at least of equivalent value. This avoids 'double counting' of the borrowing as liability and asset at the same time.

Option 6 (2 methods plus advanced method): The so-called "advanced method", proposed by ESMA, builds on the principle that each AIFM has a better understanding of its own investment strategy and should therefore be responsible for determining a calculation method that it considers an appropriate approximation of the AIF's exposure. The AIFM is entrusted to provide its own method of leverage calculation in addition to the two methods mentioned in Option 5 if it is of the view that this would provide a more meaningful result than with the gross or the commitment method.

Analysis of impacts

Option 2 (VaR): The use of VaR would not create any costs for AIFM investing in financial instruments as they calculate VaR already in the framework of their risk management and investor information. It is less common for funds investing in non-financial instruments like real estate, private equity or infrastructure as these funds trade only infrequently, often less than once per year and they could not adjust their portfolio on short notice anyway as selling such assets usually takes several months, even under normal market conditions. The VaR approach as outlined in the before mentioned CESR guidelines for risk management could therefore not be applied to these types of AIF.

Secondly, it is questionable whether the relative VaR approach provides a measure of leverage at all. CESR guidelines state that "*the VaR approach is a measure of the maxium potential loss due to market risk rather than leverage*" and note specifically that certain arbitrage strategies have low VaR but incorporate high levels of leverage. The Guidelines therefore require UCITS which calculate their global exposure using VaR methodology to also regularly monitor their leverage. While applicable to UCITS funds that can only invest into transferable securities, liquid financial instruments which usually have a market price, it would be impossible to set up a reference portfolio where "*the risk profile of the reference portfolio should be consistent with the investment objectives, policies and limits of the [AIF] portfolio.*"

AIFs typically engage in investment strategies which involve to a substantial degree taking short positions either through borrowed securities or derivatives. In order for the reference portfolio to be consistent with the risk profile of those investment strategies, the reference portfolio would need to include short positions. However, borrowing shares or including derivatives in the reference portfolio means that such a reference portfolio is no longer unleveraged. As the unleveraged reference portfolio would differ considerably from the AIF portfolio, the resulting relative VaR would not provide a reliable measure of leverage.

Furthermore, the VaR approach contains several technical drawbacks: it utilises correlations which have a propensity to break down in stressed market conditions, this means that it is the less reliable the more critical the situation is. It utilises past performance data which cannot predict future market developments and it is based on a model that underestimates the importance of extreme values. Therefore, and despite the fund industry's support for this approach, this option has to be disregarded as a method to calculate leverage. This does not mean, however, that it is discarded as a useful tool in the risk management of a fund and/or useful information for investors in assessing the investment.

Option 3 (Gross approach): The gross approach is all encompassing and, apart from minor issues (cash and borrowings to some extent), does not allow for any adjustments in order to exclude such forms of leverage which are used for the sole purpose of reducing the risk in the AIF. It is therefore argued that the resulting figures will in many cases be exorbitantly high and not a good reflection of the 'true' exposure of the AIF. However, the first argument could rather be seen as a good reason to go for this measure as it reflects fully the extent to which the AIF is active in markets (its overall "footprint") and not only a limited number of investments which are regarded as relevant. The gross approach would provide a complete picture of the AIF's involvement in markets. Investors would see how much AIFs use derivatives and other means of leverage and then decide if they prefer more or less active funds. For supervisors the gross approach would be helpful to get a better understanding of the extent of the activities in the market. AIFM with a relatively low profile under VaR or the commitment approach might turn out to be key actors in the sector. It is, on the other hand true, that the gross approach does not take the economic impact of investments on the risk profile of a fund into account.

As the method is not being used at the moment, it might lead to some confusion in the sector if and when it was introduced. Investors might have problems comparing it to other information they currently receive like VaR or leverage according to the commitment approach. However, one should assume that professional investors are in the position to understand these differences and interpret them correctly. In order to facilitate this, AIFM might launch an educational campaign to explain the concept to their investors if they see a need for this. This might be particularly needed for AIF which AIFM intend to market to retail investors under national regimes as well. As AIFMD sets minimum requirements for the marketing of AIF to retail investors as well, the leverage figure calculated with the gross approach would therefore also have to be disclosed to them.

Although the gross method was strongly opposed by industry participants in the consultation by ESMA, it has its merits and comes probably closest to the broad definition of leverage in the Directive as quoted in the beginning, 'any method … any other means'.

<u>Option 4 (Commitment approach)</u>: The commitment approach is well-established for UCITS funds. It would therefore not represent a major burden for those AIFM who manage both types of fund to calculate leverage of AIF under this approach as well. Furthermore applying the same rules to AIF and UCITS funds would enhance the coherence of the entire fund industry and facilitate comparison of leverage between different funds.

Fund managers argued that allowing only for the exclusion of arrangements that do not aim at generating a return may lead for many AIF to results not much different from the gross method as not many arrangements would comply with the requirements. This argument can be countered by noting that dropping this requirement would open the door for arbitrary assessments by AIFM of whether investments serve to reduce risk or to generate returns as in theory any combination of two assets which are not perfectly correlated could be regarded as risk-reducing. While this risk is heavily mitigated for the commitment method in the elaborated and well-established risk management guidelines for UCITS funds, this would not be the case for the advanced method. This discretion would make it hard for investors to compare disclosed leverage figures and for supervisors to get an overall view of the sector. One would also loose the advantage of comparability with UCITS funds.

In summary, the commitment approach would significantly improve investor protection by providing useful and comparable information about leverage for a broad spectrum of AIF, but it might be less useful for some AIF which use investment strategies which are not fully reflected by the commitment approach; similarly for prudential oversight by competent authorities: only for a limited number of AIF comparison of leverage figures will be less meaningful because of the nature of the underlying investment strategies. The additional administrative burden would be limited or nil for AIFM who already calculate leverage on the basis of the commitment approach.

Option 5 (2 methods): If no single method can achieve the objectives it has to be considered whether a combination of them might produce a better outcome. As the VaR had been rejected for not being an appropriate method, options 3 and 4 could be considered. The gross method gives an undistorted picture and would therefore be a good complement to other more 'economic' commitment approach. The commitment approach is well established and recognised in the sector and would allow easily for comparison with the leverage figures reported for UCITS funds. The reporting of the leverage calculated with these two methods would therefore be appropriate to depict the leverage of AIFs. Investors and competent authorities could compare these figures and draw their own conclusions, e.g. with regard to the degree to which hedging and netting strategies are being used. Whenever leverage calculations are referred to in other provisions of the AIFMD or the implementing measures, it will be specified which one has to be used.

Option 6 (Advanced method): This option would add the 'advanced method' to the previous option as proposed by ESMA. The advanced method would provide AIFM with considerable discretion when calculating leverage. In an optimistic scenario this would result in leverage figures which are very appropriate reflections of the 'true' or 'economic' leverage of the fund. In a pessimistic one AIFM would use it to design 'their' methods in a way that gives low leverage figures in order to avoid closer oversight and reporting requirements and to pretend towards investors and supervisors that the AIF was a safe investment. Reality might lie somewhere in-between these two extremes: many AIFMs continue using their current methodology which might be the commitment approach for more UCITS-like funds and VaR for many others. It could, however, not be taken for granted that they do not use 'tailor-made' versions thereof. In any case the risk would be that many different methods coexisted which do not lend themselves to comparison with other funds or an aggregate view for supervisors. Therefore, it is doubtful if allowing for this additional method would contribute positively to the objectives of investor protection and proper supervision. It is argued that the advanced method would be useful for AIFs following certain non-linear investment strategies because the first two methods of calculating leverage would report high figures disconnected from the true economic risk. However, the leverage metric is not meant to capture investment risk of the portfolio but rather AIF's involvement in the financial markets and its contribution to systemic risk. If a few AIFM used not only single different method but each of them a method tailor-made according its considerations nothing would be gained in terms of investor protection, market efficiency or prudential supervision as these figures would not be comparable among each other nor with the figures produced under the commitment approach and could not be aggregated either.

Impacts on stakeholders

Proper and harmonised calculation of leverage should benefit many stakeholders; in particular investors who would get useful and comparable information that should help them in their investment decisions. Competent authorities, ESMA and ESRB would benefit as this information would help them in assessing the situation in the AIF market but also in other (financial) markets in which AIFM invest in. This improved work by supervisors should in turn decrease (systemic) risk in financial markets to the benefit of everybody as tax payer, beneficiary of state payments or investor.

The costs involved in the calculation of the leverage figures would have to be borne by AIFM, but would most likely be rolled over to the AIF and thereby investors in the funds. The extent of the cost would very much depend on the extent to which AIFM use leverage, i.e. borrow money or invest in derivatives. Broadly speaking, it would affect funds that engage in these activities or similar strategies more than funds investing in non-financial assets, e.g. real estate, and have a lower turn-over or trading frequency. As the risk management tools of the former category of AIF should also be more sophisticated they should already cover at least part of these calculations.

Comparison of options

Except for option 2 where leverage is directly calculated, the options focus on the calculation of the exposure of the AIF. The exposure of the AIF represents the extent to which the AIF is engaged in markets through transactions or by any other form of commitment. Once the exposure is determined, the leverage is calculated by dividing the exposure by NAV.

Options 3 and 4 represent different approaches regarding the extent to which the AIFM is permitted to reduce the exposure figure through manipulations which should take into account the fact that certain exposures might net each other out or that the sole aim of certain exposures is to reduce the overall risk of the portfolio.[23] Derivatives are treated in options 3 and 4 in the same way as in section 6.2.

No single method can achieve the objectives to a satisfactory extent. The results produced by the gross method are consistent with the objective to monitor macro-prudential risks, i.e. enabling the effective monitoring of systemic risk, but do not give a proper picture of what is economically at stake. The commitment method gives better insight into the investment strategies of the AIF but netting and hedging of positions might not allow investors and supervisors to get a full picture of the activities of the AIF. The advanced method has the disadvantage that, even if it might produce most accurate information about the leverage of a particular AIF, these figures would not be comparable and could not be aggregated. Furthermore, there is a risk that the freedom in the design of the method would be used to produce artificially low leverage figures. The preferred option is therefore option 5 which combines, at reasonable costs, the benefits of options 3 and 4 without major additional downsides.

ESMA recommended option 6 in its technical advice, where options 4 to 5 would be compulsory for all AIF, and AIFM would have the right to calculate and report leverage on the basis of the advanced method in addition, upon notification to the competent authorities.

In the responses to the ESMA consultation on their draft advice, many industry participants strongly disagreed with the gross and the commitment approach. Many considered the gross method as deeply misleading as it would give biased information, not the 'true economic exposure of the AIF', to investors and competent authorities. They argued that leverage was not a measure of risk and that it should be replaced by other methods like the VaR or measures of the volatility of the AIF's assets.

These arguments have been carefully analysed but have been disregarded as they, firstly, focus on risk measurement, not on leverage measurement and, secondly, equate volatility with risk and risk with leverage which is not an appropriate approach for the discussion at hand and does not reflect the objectives to be achieved with the issue. The objective of the reporting of leverage is not primarily linked to risk management but to provide an indication of the 'true' involvement in or potential impact of AIF or AIFM on markets. A risk measure like VaR would not provide a useful tool for the calculation of total assets under management (see issue 1 above).

[23] See glossary on annex 1 for more detailed descriptions of these methods.

Table 4: Calculation of leverage - comparison of options

	Effectiveness				Efficiency
	Macro-prudential supervision	Supervision	Market efficiency	Investor protection	Limiting administrative burden
Option 1: no action	0	0	0	0	0
Option 2: VaR	0	0	0	0	++
Option 3: Gross	++	+	+	++	-
Option 4: Commitment	++	+	+	++	-
Option 5: 2 methods	++	+	+	++	-
Option 6: Advanced	-	+	+	-	-

ESMA conducted a Cost/Benefit analysis on a combination of the gross and commitment methods plus the advanced method as an option. Even if the retained option slightly differs from the ESMA advice their analysis is useful. In their view, this solution harmonizes the calculation across the EU, provides robust standards derived from the UCITS regime and ensures a comprehensive oversight of complex strategies / derivatives instruments in order to monitor the micro-prudential risks. ESMA concluded that calculating more than one method may result in additional initial costs to set up the technological infrastructure but should facilitate the monitoring of systemic risk by competent authorities.

6.4. Issue 3: Additional own funds

The Directive requires AIFM to hold capital in order to cover potential risks/liabilities resulting from their operations. These capital requirements consist of three layers. The first one is an absolute amount of initial capital. On top of this, AIFM have to hold additional capital as a function of the value of the AIF portfolios they manage. The third layer which is addressed in this level 2 measure is intended to cover potential professional liability risks. AIFMs are required to hold either additional capital to cover potential liability risks from professional negligence or professional indemnity insurance (PII) to cover such risks.[24]

1st step: Determination of the basis for the calculation of additional own funds/PII

To determine the appropriateness of these funds or PII, three main features have to be specified: firstly, what should be the basis for the calculation of additional own funds and secondly, how should this basis be calculated and finally, what would be the amount or percentage of this basis that has to be held as additional own funds. As the basis has to be decided first, the options considered focus on this aspect. The appropriate percentage to be held would then be a second step, or sub-option.

As regards the basis, there are three basic options that could be considered and variants or combinations thereof. The calculation could be based on the income of the AIFM, on the assets under management by the AIFM or could be set at an absolute value, identical for all AIFM. The first two options could be amended with a minimum threshold and/or a cap or could be combined with each other. As the level 2 empowerment refers to "*appropriateness of additional own funds*", the third basic option can be disregarded right away: A 'one-size-fits-all' approach could not be appropriate.

Option 1 (no action): No action is not a viable alternative given the legal obligation for the Commission to adopt harmonising level 2 measures.

24 In the following, for sake of simplicity, the term "additional own funds" should be read as 'additional own funds or PII". Where necessary the two approaches will be distinguished accordingly.

Option 2 (Income): An income-based approach (the "Basic Indicator Approach") is being used in Directive 2006/48/EC relating to the taking up and pursuit of business of credit institutions, which considers operational risk to rise with the income (basically the capital cushion for operational risk is calculated on the basis of the net income). Hence, the calculation of appropriate additional own funds would be based on the relevant income the AIFM derives from the AIF it manages.

Option 3 (AuM): Alternatively, the calculation of additional own funds could be based on assets under management, which is also the basis for the calculation of additional own funds pursuant to article 9(3) of the AIFMD.

Option 4 (Combination): Additional own funds could be calculated in terms of both income and assets under management.

Analysis of impacts

Option 2: Prima facie, the income of the AIFM seems to be a better indicator of operational risk than the assets under management as the additional own funds are to cover internal operations at the level of the AIFM and not losses in the value of the assets of the AIF that might result from investments. It would, however, have the disadvantage that the relevant income would have to be defined and then calculated by all AIFM. While the value of assets under management would usually be available at relatively high frequency, income calculation would in most cases only be possible at an annual basis and the additional own funds of one year would have to be based on the income of the previous year.

Furthermore, depending on the definition of income, the calculation of income might be more open to manipulation. For example, the delegation of fund management tasks to third parties could be used to lower the income of the AIFM. In fact, this could even result in additional risks which would not be adequately covered. Such an approach would therefore set wrong incentives as it is not the intention of the Directive to promote delegation for the sake of it.

Option 3 would build on an already existing method in Article 9 (3) AIFMD, as well as in Article 7(1)(a)(i) of the UCITS Directive. Furthermore, AIFM calculate the value of AuM already now before the AIFMD takes effect so that no or only marginal additional compliance costs would result from this option.

Option 3 would also help to improve investor protection and market integrity. But as for income, it is not necessarily the case either that liability risks rise with the value of the portfolio of AIFM. A manager with a low number of activities and therefore relatively lower risk of operational failures could nevertheless manage a large portfolio and vice versa. At first glance, option 4, building on both indicators, could appear as a good compromise, balancing the draw backs of the two options. However, combining two imperfect instruments does not necessarily create a good one. In view of the risks of option 2, such a combination might still produce less appropriate outcomes than relying solely on option 3. In addition, having to calculate additional own funds on the basis of two indicators would result in additional administrative burden for AIFM.

Impact on stakeholders

The costs of additional own funds or a PII would have to be borne by the AIFM, but would in all likelihood at least partly be rolled over to investors in the form of administrative charges. Investors would also be the primary beneficiaries of these funds. Arguably other business partners of the AIFM would also indirectly benefit from a lower likelihood of insolvency or bankruptcy of the AIFM. Failures of AIFM which result in losses to investors could undermine investors' confidence in the sector and lead to significant reallocations of funds with uncontrollable impacts on markets. Therefore, there is arguably also an indirect benefit to other market participants.

The more appropriate the basis for the calculation of the additional own funds/PII, the more effective and efficient investor protection can be achieved. This would reduce the costs to AIFM and in the end investors and increase the benefit to investors and other stakeholders outlined above. This assessment would be valid across the different types of AIFM.

Comparison of options

The above analysis shows that all options are relatively crude proxies of the professional liability risk of an AIFM. However, consultations by ESMA and discussions among supervisors, produced clear preferences for the use of AuM as the better indicator than income and readily available. Option 4 would render procedures more complicated without providing clear additional benefit compared to option 3. In terms of administrative burden, all three options would obviously increase the burden on AIFM. As the calculation of AuM is common practice, the additional costs would be relatively limited while they would be higher for the other two options as it would be more cumbersome to specify the income of the AIFM.

In summary, option 3, basing additional own funds/PII on assets under management by the AIFM, would be the preferred option. This option was also proposed by ESMA.

Table 5: Additional own funds/PII - comparison of options, step 1

	Effectiveness Investor protection	Efficiency Limiting administrative burden
Option 1: No action	0	0
Option 2: Income	o	--
Option 3: AuM	+	-
Option 4: Combination	+	--

2nd step: Definition of the method how to calculate additional own funds/PII

In a second step it has to be defined how AuM should be calculated. The same three options are relevant as for the calculation of total assets under management (issue 1 above):

Option 3.1 (NAV): The calculation of additional own funds could be based on the Net Asset Value (NAV) of the AIF under management by an AIFM.

Option 3.2 (Total assets): The calculation of additional own funds could be done as under Option 3 (Total AuM using market value of FDI) of issue 1 describe above: The gross asset value equals the sum of the absolute value of all assets, whether acquired through borrowed money or with investors' money. Derivatives are to be valued at their market price.

Option 3.3 (Total assets using underlyings): The calculation of additional own funds would be done in the same way as in option 3.2 with the only difference, that derivatives have to be converted into an equivalent position in the underlying asset.

Analysis of impacts

With regard to option 3.1 (NAV) more or less the same analysis as above applies: it gives you only 'half of the story' as liabilities and assets acquired through them would be excluded.

There is, however, no reason at all why professional negligence could not occur with respect to these assets and liabilities. Were the calculation of additional own funds based on NAV, these funds could be insufficient for AIFM managing AIF with significant liabilities. This would put the achievement of the objective of greater investor protection (partly) in jeopardy. There would be a bias in favour of AIF with high liabilities.

It has also to be taken into account that, while everybody uses the term 'NAV', no uniform definition of it or calculation rule exists. The use of NAV would not create significant costs in the calculation of additional own funds.

Option 3.2 (Total assets): For most funds the value of total assets is, sometimes considerably, greater than the NAV. Like option 3.1, the calculation of total assets would not create significant costs in the calculation of additional own funds. It would, however, be a more appropriate indicator of the liability risks of an AIFM than NAV as it would reflect the whole portfolio and not only net assets. Therefore, the resulting additional own funds would be more appropriate and there would be no bias towards AIF with higher liabilities. It would thereby better contribute to the achievement of the objectives.

Option 3.3 (Total assets using underlyings): This option would result in higher values of portfolios than options 3.1 and 3.2 for AIFs using FDIs thus, everything else equal, leading to higher additional own funds than the previous options. Contrary to the case of the calculation of total assets under management, the calculation of additional own funds does not focus on the potential risks of assets, but rather on the value of the assets themselves. It does, therefore, seem appropriate to gear additional own funds to operational risks rather than to implicit market risks of assets. Operational errors in the context of FDIs are *per se* not different from those in the context of non-derivative assets. It would also be inherently difficult to determine the percentage figure of the total assets AIFM would have to hold as additional own funds. A figure that might seem appropriate for AIF using derivatives extensively would result in very low additional own funds for AIF not using derivatives. A figure that would ensure reasonable additional own funds for the latter would result in possibly prohibitively high additional own funds for the former.

Impacts on stakeholders

The more appropriate the method for the calculation of the additional own funds/PII, the more effective and efficient investor protection can be achieved. This would reduce the costs to AIFM and, in the end, to investors and increase the benefit to investors and other stakeholders outlined above. The impacts on AIFM would differ the more, the more use they make of derivatives and cash borrowing.

Comparison of options

In terms of costs of the calculation itself, there should be no difference between the three options as all of them are being used (options 3.1 and 3.3) or are an intermediate step in the calculation of the others (option 3.2). The 'costs' in terms of additional own funds to be set aside or insurance premium to be paid cannot be effectively compared at this stage as the would obviously depend on the percentage figures, i.e. on which share of the funds under management would have to be set aside or on how high the PII would have to be. Assuming identical figures across the three options would produce highest costs for AIFM under option 3.3, then 3.2 and lowest costs under option 3.1. Similarly, investor protection would in theory be highest under option 3.3, then 3.2 and lowest under option 3.1. However, as option 3.1 would risk to underestimate additional own funds for AIFM of funds with high liabilities while option 3.3 would risk to overestimate operational risks in some cases this 'ranking' in terms of investor protection seems questionable. Both methods would lead to biases between AIF and would risk achieving the objective of investor protection to a lesser degree than option 3.2.

One argument that could be brought forward against option 3.2 is that it introduces (yet) another concept of how to calculate the value of portfolios of AIFs managed. However, as this does not create additional costs as total assets will be calculated anyway, and as the different calculation methods serve different purposes and as the results are only the basis for the calculation of additional own funds and not for publication, this disadvantage is compensated by the greater appropriateness of the method.

In short, using NAV would not help much to improve investor protection but would, for most types of fund, because of its availability not represent a major cost burden. Under option 3.3, additional own funds or PII would arguably be highest but at the same time costs would be very high for many AIFM. Option 3.2 is therefore the preferred option as it strikes the appropriate balance between costs and benefits. ESMA did not specify this aspect in its technical advice to the Commission.

Table 6: Additional own funds/PII - comparison of options, step 2

	Effectiveness Investor protection	Efficiency Limiting administrative burden
Option 3.1: NAV	0	0
Option 3.2: Total assets	++	-
Option 3.3: Total assets using underlyings	++	--

3rd step: Determination of the appropriate amount of additional own funds/PII

The final step in the analysis, the determination of the multiplication factor for additional own funds/PII, is presented in Annex 11 as no clearly defined options could be identified. With regard to the additional own funds, the preferred option of ESMA is retained. With regard to the PII, the preferred option is to 'straighten out' the ESMA proposal by abolishing the minimum threshold, which would represent a considerable burden for AIFM who want to opt-in, and the maximum cap which seemed arbitrary and would provide an unjustified advantage to big AIFM.

In summary, the preferred option would consist of additional own funds which would amount to 0,01% of AuM, calculated as gross assets valuing derivatives, not their underlying assets, or a PII with a coverage of 0,9% of AuM, calculated as for additional own funds, for the aggregate of claims per year and 0,7% of AuM per individual claim. The percentage points with regard to the additional own funds are those suggested by ESMA with some reference to the Capital Adequacy Directive. The figures for the PII deviate from those proposed by ESMA in so far as a minimum threshold and a cap on the requirements have been rejected as they were regarded as unjustified advantages for bigger AIFM and a disadvantage for smaller ones. The resulting coverage for average AIFM, however, hardly differs from the one under the ESMA proposal.

6.5. Depositary

6.5.1. Overview

The definitions of (i) the scope of custody; (ii) an external event; and (iii) the conditions of monitoring AIF's cash flows have been identified as areas which are key to investor protection and depositary liability and where substantive alternatives exist. For instance, the wider the scope of financial instruments to be held in custody is defined, the more of such financial instruments are covered by the stronger depositary liability standard, and the higher investor protection would be. Similarly, the narrower the definition of external events, the wider the depositary liability standard for the loss would be, and the higher the investor protection would be. The following sections discuss the various alternatives in the three areas mentioned above.

6.5.2. Issue 4: Scope of custody

Background: depositary safe-keeping duties

The principal aim of Article 21(8) is that custody extends to all financial instruments that can be registered in accounts on the depositary's books or that can physically be delivered to the depositary.

According to Article 21(8) AIFMD all assets of an AIF (or the AIFM acting on behalf of the AIF) shall be entrusted to the depositary for safekeeping. This implies that all assets owned by an AIF must be registered in a financial instruments account opened in the depositary's books. In line with the trend that physical records pertaining to financial instruments are replaced by electronic records (dematerialisation), this registration commonly occurs in the form of an electronic book entry.

Article 21(8) then introduces a distinction between financial instruments that can be held in custody and "other assets". In relation to financial instruments that can be held in custody, Article 21(8)(a)(i) requires the depositary to hold in custody "all financial instruments that can be registered in a financial instruments account opened in the depositary's books" (Article 21(8)(a)(i) AIFMD). In relation to "other assets", Article 21(8)(b)(i) requires that the depositary verifies the ownership of the AIF of such assets and keeps a record thereof. There is no obligation to keep these other assets in custody.

The AIFMD does not contain an autonomous definition of what constitutes a financial instrument. Article 4 AIFMD contains a reference to Section C of Annex I to Directive 2004/39/EC (MiFID). This implies that for instance physical assets that do not qualify as financial instruments or cash deposits with a third party entity would not be held in custody.

As the empowerment contained in Article 21(17)(c)(i) AIFMD refers to measures specifying the "types of financial instruments" included in the scope of custody, and does not refer to "types of transactions" involving these financial instruments or provide any further qualification, the scope of custody is not dependent on whether financial instruments are subject to particular arrangements, such as repo transactions, securities lending or security interest collateral arrangements. Otherwise, one of the core provisions of the AIFMD concerning investor protection would be of little effect, as at any given point in time a large amount of the assets belonging to an AIF could be subject to any of the above arrangements.

Background: book-entry securities

As mentioned above, financial instruments are nowadays issued in the dematerialized/immobilized form of electronic records. In other words, such instruments are issued in book-entry form. Electronic records are in general not maintained by the issuers but by intermediaries. Intermediaries that record the issue in their books in dematerialized form are, for example, Central Securities Depositaries (CSDs), which operate so called securities settlement systems, or registrars.

Settlement systems play a crucial role in the transfer of dematerialised securities. A settlement system maintains accounts in favour of its members. These members act as custodians for other market participants.[25] Since membership in a settlement system is restricted to qualifying entities, AIFs would usually not be allowed as direct participants. Therefore the AIF's custodian, which is usually a direct participant[26] in the settlement system, would act on behalf of the AIF.[27] When a market participant, e.g., an AIF, wishes to transfer assets to another market participant both participants send matching electronic instructions (either directly or via their custodians) to the settlement system. The settlement system then debits the account of the AIF and credits the account of its counterparty. Such account entries are commonly referred to as 'book entries'. The legal consequence of the above described debits and credits is that property rights are transferred to the AIFs counterparty. This arrangement is commonly referred to as book entry transfer.

A second important consideration is the name in which the financial instrument is registered at the registrar or in which the account at the CSD is opened. If it was not in the name of the AIF, the registrar or the CSD would not recognize the AIF as the proper owner and the AIF would need the assistance of its custodian to exercise its rights over the financial instruments (e.g. to instruct transfer of title). Inversely, if the financial instrument is registered solely in the name of the AIF, the depositary has no ability to instruct transfer of title.

Options

Financial instruments that are commonly held in custody are defined in the ESMA advice as transferable securities, money market instruments or units in collective investment undertakings. In addition, Article 21(8) AIFMD stipulates that all financial instruments which can be registered in a financial instruments account (essentially, transferable securities, money market instruments units in collective investment undertakings), and which belong to an AIF, must be held in custody. Therefore the provisions of the AIFMD do not allow AIF assets which correspond to the above typology to be excluded from the scope of custody as long as they are still owned by the AIF - irrespective of whether these instruments are subject to particular business arrangements, such as repos, securities lending or security interest collateral arrangements[28]. Only an outright transfer of ownership would entail that the above mentioned financial instruments are outside the scope of custody. In these circumstances, it appears logical to define options on the scope of custody with reference to the depositary's involvement in the transfer of title or ownership. The following options have therefore been identified with reference to how transfer of the ownership is settled.

Option 1 (no action): No action is not a viable alternative given the legal obligation for the Commission to adopt harmonising level 2 measures.

Option 2 (Depositary involvement in title transfer): According to this option all financial instruments which could be registered with the issuer or its registrar or held in an account,[29] directly or indirectly **in the name of the depositary** would be considered as instruments to be

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[25] Each member would typically have two types of accounts: one on which financial instruments the member owns are recorded and one on which financial instruments owned by its clients are recorded.

[26] A depositary's membership in a settlement system is driven by commercial reasons. A single depositary might therefore not be a direct participant in a settlement system of a particular country. In that case, the depositary would enter into a sub-custody agreement with an entity which is a member of the system in that country.

[27] Annex 12 shows an example of a typical custody chain.

[28] This is why a general exception for all types of collateral, as advised by ESMA, would not appear compatible with the wording of Article 21.

[29] Opened at a CSD or a settlement system

held in custody. In such cases, the AIF is unable to exercise its rights over the financial instruments (e.g. to carry out a transfer of title to a counterparty) without assistance of the depositary. The aim of this option is to provide a clear framework as to the scope of custody with little room for interpretation. A clear scope of custody is important in light of the liability attached to those financial instruments that are held in custody.

In this option, for all financial instruments identified by ESMA the depositary would be obliged to hold them in custody, except for those issued in a nominative form or registered directly with the issuer or through a registrar acting on behalf of the issuer solely **in the name of the AIF**.

With this option, the depositary's custody obligation would be linked to all financial instruments over which the AIF is unable to exercise its rights without the depositary's assistance (e.g. the depositary is able to instruct the transfer of the financial instruments to another market participant, whether this transfer is settled through a settlement system or otherwise on a bilateral basis). This option is preferred by ESMA.

Option 3 (Title transfer by means of a settlement system): The third option suggests that only financial instruments with respect to which the depositary may itself or through its sub-custodian instruct the transfer of title by means of a book-entry on accounts maintained by a settlement system would be subject to custody.

As a consequence, this option would not only exclude from the scope of custody financial instruments registered with the issuer or its registrar in the name of the AIF but also those registered in the name of the depositary. . Units issued by collective investment undertakings would at present fall into this category in a number of Member States.

Table 7: Matrix of options regarding custody

1. Where is financial instrument registered? 2. Whose name is used?	Issuer's register or Registrar	Account at a Central Securities Depositary or a settlement system
Account in the name of AIF	Option 2: not in custody Option 3: not in custody	n.a.
Account not in the name of the AIF	Option 2: in custody Option 3: not in custody	Option 2: in custody Option 3: in custody

Analysis of impacts

Option 2 has the advantage of simplicity and clarity with little room for interpretation. There are no restrictions in the scope of custody due to the particular form in which the transfer of title is settled.

Under option 3 the scope of instruments held in custody would be more limited. Option 3 would exclude financial instruments from the scope of custody where the transfer of such financial instruments is not settled through a settlement system. Indeed, not all CSDs offer settlement in relation to the financial instruments registered in the CSD and not all financial instruments that can be registered in financial instruments accounts are necessarily settled through a CSD or other settlement system (e.g. certain units of collective investment schemes are registered in the funds' own register and their transfer is not intermediated by a settlement system). A range of financial instruments would therefore escape the scope of custody.

Option 3 suffers from certain arbitrariness due to its reference to settlement systems and a lack of clarity since there is no uniform and globally accepted definition of a settlement system. Nevertheless, option 3 is considered as it reflects current market practice of some depositaries and is the clear preference of the depositary industry (as expressed during the ESMA consultation). Including a broader scope of financial instruments into the scope of custody would likely be associated with some adaptation costs, at least for those custodians who currently do not safe-keep assets that are settled outside settlement systems.

Impacts on stakeholders

A clear definition and uniform delineation of the scope of custody that will apply in all countries in which an AIF is invested will provide AIFM, AIF investors and depositaries with a predictable legal framework. Legal certainty as to the precise scope of financial instruments that are to be held in custody (and that are to be returned in case of their loss) is conducive to establishing investor confidence. This is a key plank of European policies aiming to overcome market insecurities that arose in recent years, especially in the wake of the Madoff fraud.

The obligation, incumbent on the principal custodian, to return a financial instrument of the identical type or the corresponding amount would be clearly linked to all financial instruments for which the custodian in principle is able to instruct a transfer, including, under option 2, where it is the registered owner in an issuer's register. Under option 2 investors will benefit from the higher protection in the form of higher certainty in case of loss. The higher liability attached to holding instruments in custody is expected to induce high levels of diligence on the part of depositaries in carrying out their duties in order to minimize probability of loss of the instruments.

Some depositaries, which currently do not hold in custody financial instruments registered in the name of the depositary in an issuer's or registrar's register, will incur a cost of adjusting and updating their systems. Obviously, the major part of any adjustment costs will be intrinsically linked to the AIFMD's requirement that <u>all</u> assets belonging to an AIF must be entrusted to a single depositary for safe-keeping. Contrary to the UCITS universe, such an obligation currently does not exist for AIF. However, the specification that the custody requirement also applies to financial instruments registered in third party registers increases the scope of custody marginally. This approach is, despite a marginal increase in cost, however necessary to close a loophole which would otherwise arise in relation to assets belonging to an AIF that are registered in the depositary's name in an issuers register. Since changes to the range of financial instruments to be held in custody are minor, and since all of the relevant instruments are standardised, the resulting costs are expected to be incremental. Nevertheless, some depositaries might be tempted to invoke this incremental increase to the range of financial instruments they need to hold in custody to justify an increase in custody fees. The latter would indeed be borne by the AIFs and their investors.

The extension of custody to financial instruments registered in the name of the depositary in an issuer's or registrar's register is nevertheless important in the AIFMD's aim to introduce the custody function as one of the main tasks of a depositary. Therefore, and in order to guarantee a significant level of investor protection, Article 21(8)(a) AIFMD and the decisions on its implementation at level 2, will also have an effect on depositaries that act on behalf of UCITS funds. Aligning the scope of custody between AIF and UCITS funds should further harmonise the level of investor protection in relation to financial instruments that these funds invest in and, in consequence, boost investor confidence and trust in funds and fund managers domiciled and regulated in Europe. Finally, a harmonised scope of custody, will not only boost investor confidence in Europe but will also have positive "knock-on" effects on the image of European fund vehicles in third countries. This, in turn, will enhance the competitiveness of the European-based fund industry.

Comparison of options

Distinguishing the scope of custody on the basis of how title in the instrument is transferred provides a clear framework for determining the scope of custody. Options 2 and 3 are therefore equivalent in terms of legal certainty and ease of application.

However, on the downside, option 3 would exclude from the scope of custody financial instruments that can be registered in the financial instruments account in the depositary books but that are not settled through a settlement system. Reference to the settlement of securities transactions occurring in a settlement system, although advocated by some industry participants, would seem rather an arbitrary limitation of the scope of custody. The issue of whether an instrument can be held in a financial instruments account has no direct link with the fact whether transactions involving that financial instrument are centrally cleared and settled or whether this is not the case. Also, the relevant provision at level 1, Article 21(8)(a)(i) AIFMD, does not make custody dependent on how transactions involving a given financial instrument are cleared and settled. Option 3 would therefore arguably limit the scope of financial instruments to be held in custody beyond what Article 21(8)(a)(i) AIFMD (see above) provides. In consequence, this option would offer a lower level of investor protection than that required by the AIFMD.

In light of these considerations option 2 is the preferred option.

Table 8: Scope of custody - comparison of options

	Effectiveness Investor protection	Efficiency Limiting administrative burden
Option 1: no action	0	0
Option 2: Title transfer	++	--
Option 3: Title transfer by means of a settlement system	-	-

6.5.3. *Issue 5: Definition of an "external event beyond reasonable control"*

The precise definition of the contours of a depositary's liability is a core plank of the regulatory framework put in place by the AIFMD. The general aim of the AIFMD's depositary provisions, notably Articles 21(12) and (13) is to ensure a high level of investor protection concerning all assets held in custody. A high level of diligence with respect to these assets is an essential feature in ensuring that one of the objectives of the AIFMD, enhancement of investor protection, is attained.

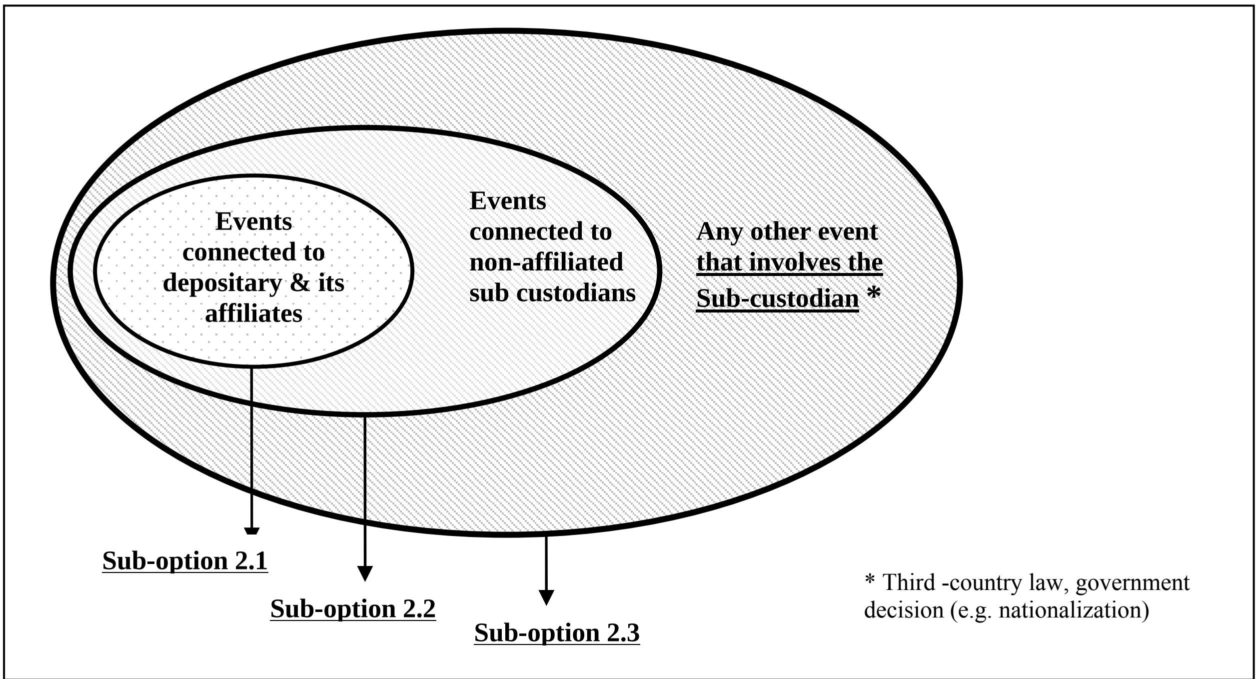
The AIFMD also aims to ensure that a delegation of tasks to a third party, the sub-custodian, shall not affect the depositary's duty to either return a financial instrument of identical type or to pay the corresponding amount to the AIF.

Implementing measures attempting to delineate or classify events as being "external" and "beyond the reasonable control" of a depositary can, however, only provide general guidance on how the legal notion of "external event beyond reasonable control" is to be defined. The precise contours of what constitutes an "external event" that is "beyond the reasonable control" of a depositary, autonomous notions of Community law that were introduced in the AIFMD, can ultimately only emerge from the jurisprudence of the European Court of Justice.

In these circumstances, this impact assessment can identify only two options for action at level 2: either the interpretation of this core legal concept is left to the European Court of

Justice or the co-legislators aim to provide guidance on the contours of what constitutes an "external event beyond reasonable control" of a depositary.

Chart 2: Delineation of what is to be regarded as "external events beyond reasonable control"



Option 1 (No further guidance on what constitutes an "external event beyond the reasonable control):

The legal notion of an "external event beyond the reasonable control" of a depositary would not be further delineated by implementing measures but this task should be left solely to the European Court of Justice. Only the latter could provide the authentic interpretation of this autonomous notion of Community law. Only such a binding interpretation by the European Court of Justice would be conducive to a uniform interpretation of this autonomous European legal notion.

Option 2 (Level 2 guidance on the contours of an "external event beyond the reasonable control"):

According to this option informal guidance on the core legal notion of an "external event beyond reasonable control" would be regarded as useful in furthering the aim of the AIFMD. This guidance would, it goes without saying, be without prejudice to a judgment by the European Court of Justice clarifying the notion of "external event beyond the reasonable control" of a depositary. The issue on what this guidance should state is dealt with in different forms of interpreting the notion of "external event beyond reasonable control" as presented as sub-options below.

Sub-option 2.1 ("External event beyond reasonable control" as an event that is outside a depositary's "corporate sphere"): The consequence of this interpretation would be that only events that occur either at the depositary or at a sub-custodian that is controlled by the depositary would not be qualified as being "external events beyond reasonable control". In other words, only financial instruments that are lost either at the depositary or at a sub-custodian that belongs to the same corporate group would need to be returned. The scope of liability would only comprise losses of financial instruments in custody that result from custodial events, such as errors in segregation, lack of segregation or fraud that takes place within the corporate group to which both the principal custodian and the sub-custodian belong.

Losses attributable to errors in segregation, the lack of segregation or fraud that is committed at the level of sub-custodians that do not belong to the corporate group of the depositary would be qualified as "external events beyond reasonable control" and, in consequence, not necessarily give rise to liability of the depositary under Article 21 (12). In consequence, the depositary would not have to return an instrument that was lost at the level of an unaffiliated custodian provided that this loss was unavoidable despite all reasonable efforts to the contrary.

A fortiori, any natural disasters or acts of state, government measures (e.g., market closures) would be classified as being "external events beyond reasonable control". If, e.g., a Government decided to nationalise any custody-providing member of the principal custodian's corporate group, the latter would not necessarily be liable for the unlikely event that this act of state would entail the permanent loss of a financial instrument.

Sub-option 2.2 ("External event beyond reasonable control" as all events that are not related to the depositary and its sub-custodians): Following this interpretation would imply that events that occur within the "chain of custody" would not be deemed "external", irrespective of whether these events happened at the level of an affiliated sub-custodian or at the level of a sub-custodian that does not belong to the same corporate group as the depositary. As in the first sub-option, any natural disasters or acts of state, government measures (e.g., market closures) would be classified as being "external events beyond reasonable control". This option is preferred by ESMA.

Sub-option 2.3 ("External event beyond reasonable control" as all events that arise as a consequence of the delegation of custody to a third party): With this interpretation, the depositary would assume unlimited liability for any event that happened subsequent to its decision to delegate custody to another entity. In addition, under this sub-option, even losses of financial instruments that occur on account of acts of state, governmental measures or natural disasters that strike at the sub-custodian's level would be considered "internal" and thus immediately be covered by the depositary's liability. The rationale behind this sub-option would be that the depositary should have to assume responsibility for all events that arise at sub-custodian level subsequent to a decision to delegate custody.

Analysis of impacts

In line with the provision contained in Article 21(12) sub-paragraph 1, which makes depositary liable for the loss by the depositary or a third party to whom custody has been delegated and in Article 21(13) sub-paragraph 1, which expressly foresees that in case of delegations referred in Article 21 (11) the delegating depositary's liability shall not be affected sub-option 2 reflects the choice of the co-legislators when adopting the AIFMD. Although level 2 guidance cannot replace the jurisprudence of the European Court of Justice, the co-legislator thought that some guidance was required to ensure the emergence of a homogenous interpretation of the legal notion of "external event beyond the reasonable control" of a depositary. Therefore, sub-option 2 best reflects choices that were taken at level 1 of the AIFMD.

With respect to the various sub-options this impact assessment will identify certain consequences that the different sub-options on legal interpretation have in terms of consumer protection and in terms of impact on the depositary industry.

Replies to the ESMA's public consultation confirm that sub-option 2.1 is the interpretation preferred by the depositary industry as it would lead to the narrowest scope of liability. The industry argues that limiting liability to events in their corporate sphere provides them with legal certainty as to their duties and the diligence that is to be applied to avoid the loss of financial instruments held in custody. The industry argues that it is easier to ensure compliance with the depositary provisions when the sub-custodian is an affiliated entity of the depositary (especially due diligence requirements, periodic review and on-going monitoring of the third party, as stated in article 21(11)).

Secondly, many stakeholders argued that the insolvency of a non-affiliated sub-custodian cannot be predicted sufficiently in advance in order for the depositary to prevent a loss that may occur in the course of insolvency. Moreover, they point to the experience that, in breach of sub-custodian obligations, clients' assets may be used before insolvency in a desperate attempt to avoid bankruptcy. In this specific case, the loss is due to fraud committed in the sub-custodian network and, it would be very difficult to discover it before the sub-custodian bankruptcy especially as inaccurate securities statements may have been provided to the depositary.

The depositary industry further argues that if they became liable for events connected to a non-affiliated sub-custodian then significant contingent liabilities could be created for depositaries. This might result in higher costs (e.g. operational costs due to the due diligence requirements in case of delegation), which would ultimately be passed on to investors via higher fees. Furthermore, they argued that, in several situations, the depositary is forced to delegate its safekeeping duties where the depositary has not decided to establish own presence in the local market where custody by a local sub-custodian is mandated by law.

On the other hand, this broad interpretation of the contours of an "external event beyond reasonable control" restricts the depositary liability to a substantial degree. First, many emerging markets require, either for practical reasons or as a matter of law, that the assets are held by a local sub-custodian. The depositary might in many of these instances appoint sub-custodians that do not belong to the same corporate group as itself and, therefore, systematically avoid liability for the loss of these assets while in custody with the sub-custodian. These markets represent a non-negligible segment of the AIF's investment universe, and the loss of these assets would mostly be borne by AIF's investors. Moreover, the broad interpretation of "external event beyond reasonable control" even opens the possibility to circumvent the effects of the custody provisions by encouraging the depositary to delegate custody to non-affiliated sub-custodians in order to minimize the level of its liability even in case there is no obligation to use a local custodian and even in case that the custodian is itself present in the relevant market.

Sub-option 2.2, by making the depositary liable for all events that are related to the depositary or its sub-custodians, encourages depositaries to conduct thorough due diligence before transferring financial instruments to a sub-custodian. One of the possible developments linked to this broader sphere of custodial liability would be that depositaries might have an incentive to set up more affiliated sub-custodians. The creation of geographically wider "custody networks" would indeed be seen as a desired result because a sub-custodian might always be better controlled by the depositary whatever safeguards, e.g., controls or due diligence, they may install with respect to non-affiliated sub-custodians. The higher cost in supervising non-affiliated custodians might thus trigger the extension of world-wide custody networks, a development that would be beneficial for the overall level of investor protection.

Finally, it must be noted that the AIFMD level 1 rules on depositaries do not distinguish between affiliated and non-affiliated sub-custodians. The broad interpretation of the notion of "external event beyond reasonable control" favoured by the industry would therefore not be very efficient in achieving the investor protection objective set forth by the AIFMD, level 1. Under sub-option 2.1, the delegation to non-affiliated sub-custodians would actually diminish the liability of the depositary compared to situations where no delegation takes place or where only affiliated sub-custodians are used.

Under sub-option 2.3, the depositary would be liable for any event which entails the loss of the financial instruments held in custody by the sub-custodian. This option does not make any distinction according to whether the event occurs at an affiliate and non-affiliate sub-custodian and whether the event is linked to custodial errors, legislative acts or natural disasters. In consequence, this very narrow way of interpreting the notion of "external event beyond reasonable control" would consider all events that arise as a consequence of sub-delegation as internal and make the depositary liable for all events that happen at the level of the sub-delegate.

The narrow scope of the notion of an "external event beyond reasonable control" arguably risks going beyond the requirements of Article 21(13). Under the interpretation outlined in sub-option 2.3 the level of depositary's liability is not maintained but increased to cover all events that occur at sub-delegate level, once custody duties are delegated to a third party. Indeed, if a government decision causes the loss of the financial instruments held in custody by the depositary, this event would not be regarded as an "external event beyond reasonable control" as the exposure of the assets in custody to this risk is a consequence of the decision to delegate custody. However, if the assets remained in custody by the depositary, an equivalent event (i.e. government decision) that induces the loss of these assets would be considered as an "external event beyond reasonable control".

Moreover, this narrow interpretation of the notion "external event beyond reasonable control" would impose excessive operating costs due to the need to foresee and avoid all sorts of risks related to all events that occur at the sub-custodian level. These additional costs will be undoubtedly paid by the investors. Alternatively, the depositaries would be reluctant to agree to hold assets for clients in those markets via sub-custodians thereby reducing investor choice.

Impacts on stakeholders

In a nut shell, one could say that the level of investor protection and of resulting costs increase from sub-option to sub-option. However, while the gain in investor protection from sub-option 2.1 to sub-option 2.2 seems to be substantially greater than the increase of cost, the reverse seems to be the case when moving from sub-option 2.2 to sub-option 2.3 as depositaries would have to take on risk which they could hardly control. Sub-option 2.2 therefore appears to bring the best ratio between cost of custody and benefits - in terms of investor protection. This option also appears the most equitable as it considers as external those events not related to the operational sphere of a depositary or its appointed network of sub-custodians (a sphere which the depositary controls by virtue of its sub-custody arrangements, cf. Article 21(11) AIFMD. In the event of insolvency of a sub-custodian, operational failures by the latter (e.g. failure to implement the segregation requirement, cf. Article 21(11(iii)) would <u>not</u> be an "external event".

Sub-option 2.2 would incentives depositaries to select and monitor sub-custodians in an adequate manner. This incentive, in turn, would bring about the desired improvements in investor protection and would essentially ensure that the delegation of custody does not have negative repercussions for investors in AIF.

Provisions to cover the obligation to return losses that arise as a consequence of all kinds of governmental measures and of national disasters at the sub-custodian level in sub-option 2.3 would far exceed those that would be necessary in sub-option 2.2. Furthermore, obliging the depositary to provision for essentially unforeseeable and hard to control events would not provide any reasonable incentives: the depositary would not be able to control such events in any case.

Comparison of sub-options

Under sub-option 2.1, the delegation of custody to non-affiliated sub-custodian decreases the liability level of depositary compared to similar situations where the assets are held in custody by the depositary. In these circumstances, the delegation of custody can be used by the depositary to circumvent the AIFMD obligations. In contrast, under sub-option 2.3, the delegation would increase the liability level of the depositary. Sub-option 2.2, in line with Article 21(13), considers a delegation as a "neutral" act which does not affect the depository liability. It balances between ensuring a high level of investor protection while providing the needed flexibility to the depositary's industry and not putting the entire responsibility on the depositaries. This way of interpreting the notion of "external event" satisfies the need of investor protection and ensures that the delegation of safekeeping duties will not be used by depositories to circumvent their obligations.

In these circumstances, sub-option 2.2 displays the best profile in terms of regulatory efficiency by setting appropriate incentive structures. It ensures an appropriate level of investor protection and also seems to be closest to the legislative intent expressed in Articles 21(12) and 21(13). It is therefore the preferred option.

Table 9: Definition of 'external event' - comparison of options

	Effectiveness Investor protection	Efficiency Limiting administrative burden
Option 1: no action	0	0
Option 2: interpretative guidance at level 2		
Sub-option 2.1: Depositary's "corporate sphere	-	+
Sub-option 2.2 Depositary and its sub-custody network	+	-
Sub-option 2.3: All events related to custody delegation	++	---

6.5.4. Issue 6: Scope of cash monitoring

The AIFM Directive requires the depository to ensure that AIF's cash flows are properly monitored. In this respect, it has to ensure that:

- all the payments made upon the subscriptions of units or shares of AIFs are received

- all the cash of the AIF is booked in proper cash accounts opened at an entity which complies with the provisions specified in Article 21 (7) AIFMD.[30]

The depositary duty to ensure that AIF's cash flows are properly monitored serves the objective of investor protection. Since materially different degrees of intensity of monitoring

[30] According to the Article 21 (7) of the Directive 2011/61/EC (AIFMD), the cash account has to be opened at an entity referred to in points (a), (b) and (c) of Article 18(1) of Directive 2006/73/EC, or another entity of the same nature, in the relevant market where cash accounts are required provided that such entity is subject to effective prudential regulation and supervision which have the same effect as Union law and are effectively enforced and in accordance with the principles set out in Article 16 of Directive 2006/73/EC.

of AIF's cash flow could be envisaged, this could lead to inconsistencies in or inappropriateness of depositary duties to the detriment of investors.

Option 1 (no action): No action is not a viable alternative given the legal obligation for the Commission to adopt harmonising level 2 measures.

Option 2 (Ex-ante authorization regime): Option 2 would be an ex-ante authorization regime, by which the depositary would have to sign off every cash flow instruction before it is executed. Such a solution aims at strongly reducing operational risks by providing a maximum control over cash.

Option 3 (Central hub of information): Under option 3, the depositary would be considered as a central hub where all information related to the AIF's cash flows is centralised, recorded and reconciled in order to ensure an effective and proper monitoring of all cash flows, which as a fungible asset, can be easily distracted and subject to fraudulent conducts. Specifically, the depositary would record periodically the transactions on those cash accounts into a position keeping system and make periodic reconciliations between the cash accounts statements and the information received about the AIF's subscriptions, redemptions and investment activity (assets held in custody and other assets) and check the consistency of its own records of cash positions with those of the AIFM. To enable the depositary to achieve that, option 3 would require instructions related to third party cash accounts to be sent without undue delay (from the AIFM or the third party entity) to the depositary. As a consequence, the depositary could intervene immediately if it considered a cash flow inconsistent with AIF's operations. However, this does not mean that the depositary would take part in the management of the AIF. The investment decisions remain in the sole hands of the AIFM. The frequency of reconciliations between the accounts should be proportionate to the nature, scale and complexity of the AIF.

Option 4 (Verification of procedures): Under option 4, the depositary's obligations would consist in verifying that there are procedures in place to appropriately monitor the AIF's cash flows and that they are effectively implemented and periodically reviewed. Those procedures could be internal to the depositary or could be performed by the AIFM itself, its accountant/administrator or another service provider. In particular, the depositary would be required to look into the reconciliation procedure(s) to satisfy itself that they are suitable for the AIF and performed at an appropriate interval taking into account the nature, scale and complexity of the AIF. Such a procedure should compare one by one, on a frequent basis, each cash flow as reported in the bank accounts statements with the cash flows recorded in the AIF's accounts. The depositary would then define its own verification procedures accordingly. For example, where reconciliations are performed on a daily basis (e.g. for most open-ended funds), the depositary would be expected to perform its verifications at least on a weekly basis. The depositary's verification procedures would consist in:

- monitoring on a regular basis the discrepancies highlighted by the reconciliation procedures and the corrective measures taken in order to notify the AIFM of any anomaly which would not have been remedied without undue delay;

- conducting a full review of the reconciliation procedures, i.e. going through the whole reconciliation process with the third party in charge of it to ensure it remains appropriate and is effectively implemented. ESMA suggests that such a review should be performed at least once a year;

- ensuring that the AIFM or its service provider implements on a timely basis significant cash flows and in particular those which could be inconsistent with the AIF's operations (e.g. with respect to changes in positions in AIF's assets or subscriptions and redemptions); and

- receiving periodically cash account statements and checking the consistency of its own records of cash positions with those of the AIFM. The depositary should maintain its record up to date according to Article 21(8)(b).

This option is preferred by ESMA.

Analysis of impacts

In an **ex-ante authorization regime (option 2)**, the double signature requirement (AIF/AIFM and depositary) would reduce the possibility of fraudulent transactions and facilitate the implementation of proper monitoring duties by the depositary. It would reinforce investor protection, notably by reducing the risk of potential fraudulent cash movement. Besides, requiring the depositary to book the cash in only one account would limit potential circumvention practices by the AIFM consisting in opening many cash accounts which could be used in order to avoid monitoring by the depositary.

However, such a regime could hinder a timely execution of operations and would be hardly workable in practice when the frequency of the transactions is high. In some situations, the legal obligation of the AIF to make the settlement will exist as soon as the bargain is struck, that is to say before the depositary can be aware of the payment. The industry stressed that the number of payments to check (which reach over 100,000 cash movements each day in some cases) would be beyond the ability of the depositaries. Secondly, it creates a risk of miscommunication and missed settlement deadlines. There is also a risk that the depositary interferes with the AIFM investment decision because its agreement can be used as a veto right.

Moreover, the cost in terms of infrastructure and resources to meet this requirement would be very high. The industry estimates that implementing new systems architectures and processes would cost several times their current annual technology budget. Finally, such an option may create systemic risk if AIFs managed by European AIFMs cannot settle delivery-versus-payment (DVP) with counterparties outside Europe anymore. In a word, this option implies the highest degree of monitoring (to complement the oversight already provided by the DVP system) but also the highest implementing and running costs for the industry.

A parallel information and periodic reconciliation regime **(option 3)** would require the AIFM to instruct the third party where the cash accounts are opened to inform simultaneously both the AIFM and the depositary about all the cash flows. Such a regime would guarantee a high level of concomitant verification of third cash accounts by the depositary without much of the cost associated to the ex-ante authorization regime. For instance, any impact on the execution of operations and settlement would be avoided. Since the depositary is unlikely to be privy to information regarding cash movements held in accounts with third parties intra-day, the reconciliations would be performed on ex-post basis. This would allow the depositary to automate the process, where appropriate, and check even a large number of transactions.

Requiring daily reconciliation of all cash flows by the depositary would mitigate operational risks and reduce the possibility of pending transactions. The risk of fraud would also be significantly reduced but would not be totally avoided. In addition, the information generated by the reconciliation of cash flows has to be stored and ready for retrieval. Such storage would lead to incremental costs for depositaries. Costs related to this regime would depend on the modality of the reconciliation, in particular the level of detail required for the reconciliation and the frequency with which the reconciliation has to be performed. The more detailed and frequent, the costlier it would be for the depositaries and ultimately for investors.

In a regime based on **verification of procedures (option 4)** the depositary would have to verify that appropriate reconciliation procedures are performed frequently by the AIFM or another entity and to monitor on an on-going basis the outcome of those procedures. The depositary would also be required to go through the entire reconciliation process itself at least once a year. The depositary would have to verify that the AIFM or another entity would implement procedures to identify transactions that are significant or inconsistent with the AIF's operations. It would require relatively lower implementing and on-going costs on the side of the depositaries, AIFM and third parties than the other options. That is why the industry strongly expressed its preference for this option during ESMA's targeted engagement organised on 11th March 2011.

However, this option provides a weaker monitoring regime for AIF's cash flows. At present, there is no direct substantive obligation in the EU legislation (e.g. as regards accounting) on AIFMs or other entities to actually perform reconciliations. In this situation, the performance of reconciliation would depend on the own initiative of the AIFM or the third party and the depositary would not be in the position to ensure that the AIFM or other entities to perform the reconciliations or whether the frequency of reconciliations is appropriate. Consequently, the depositary would also not be in the position to verify outcomes of the reconciliations or the adequacy of the reconciliation procedures. This would lead to legal uncertainty as to whether the depositary has discharged of its monitoring duties. An additional weakness of this regime is that the depositary would rely entirely on effectiveness and reliability of procedures to be implemented and under control of the AIFM (i.e. the effectiveness of self-monitoring by the AIFM). The depositary would also have to rely on the AIFM to provide the depositary with accurate and timely reports on the outcome of the reconciliations. Consequently, this regime provides for less effective cash monitoring regime where substantial operational risk and risk of fraud would remain.

Impacts on stakeholders

Impacts on stakeholders are on the one hand the costs involved in the monitoring process of cash flows which decrease from option 2 to option 3 and to option 4. These costs would occur at the depositary but would most likely have to be borne by the investors as the depositary will pass them on the AIF and the AIF, in turn, to investors. Besides the costs of operating the systems there are the opportunity costs involved in option 2 in particular. This very strict regime would bear the risk that certain deals could not be concluded or obligations not be fulfilled because of the requirement of ex-ante control. On the other hand, AIFs and ultimately their investors will benefit from depositary's oversight over AIF's cash flows as this will reduce the risk of failures or even abuses. Here the order of effectiveness is the same: it decreases from option 2 to option 3 and to option 4. Again, there is a risk that for option 2 the additional investor protection resulting from the avoidance of mistakes or abuses would be compromised through the new risks triggered by the regime. This means that option 2 would potentially increase legal uncertainty while options 3 would create greater legal certainty for the depositary as well as the AIFM. Since there is no direct obligation on AIFM or another entity to perform the reconciliations or identify inconsistent transactions, option 4 would also leave legal uncertainty for the depositary in case the AIFM does not perform the reconciliation or the frequency of reconciliations is not appropriate. Options 3 and 4 avoid delaying the settlement of investment transactions. Option 3 would bring higher operational costs compared to option 4 since the depositary would perform the reconciliation.

Comparison of options

Option 3 and 4 avoid the costs of delaying transactions inherent in option 2. Option 3 provides for more effective and reliable cash monitoring than option 4 since the AIFM is not required to perform the reconciliations or identify inconsistent cash flow and the depositary would not rely on self-monitoring by the AIFM.. The cost comparison between options 3 and 4 is mixed: while option 3 entails higher operating cost than option 4, option 4 carries costs related to legal uncertainty for the depositary. Option 3 is based on ex-post monitoring of cash flows and provides flexibility and workability for an efficient investment process while ensuring a high degree of investor protection. Therefore option 3 is the preferred option.

Table 10: Cash monitoring - comparison of options

	Effectiveness Investor protection	Efficiency Limiting administrative burden
Option 1: no action	0	0
Option 2: ex-ante authorization regime	++	--
Option 3: central hub of information	++	-
Option 4: verification of procedures	-	-

6.6. Issue 7: Reporting to competent authorities

Article 24 AIFMD already prescribes a number of issues on which AIFM will have to provide information.[31] It does not, however, indicate at what frequency this reporting should take place but leaves it entirely to level 2 measures which should take into account the need to avoid an excessive administrative burden on competent authorities.

Setting the appropriate reporting frequency requires finding the right trade-off between the costs involved in the reporting for AIFM and competent authorities on the one hand, and the need of supervisors to have up-to-date information available on the other. The reporting frequency could be set according to various criteria like the size of the AIF or the AIFM in terms of assets under management, the types of assets under management, or the level of activity of the AIFM. Another option would of course be not to make any distinction but to require all AIFM to report at the same frequency.

From these considerations, six options can be derived and combinations of the options could also be envisaged.

Option 1 (no action): No action is not a viable alternative given the legal obligation for the Commission to adopt harmonising level 2 measures.

Option 2 (No differentiation): All AIFMs, irrespective of their size or type, would have to report at the same frequency. As for systemic risk reasons, in the view of ESRB, (at least) quarterly reporting by potentially systemically important AIF seems to be necessary, all AIFM would have to report on a quarterly basis to their competent authorities.

Option 3 (Asset type): AIFMs would have to report at a frequency varying according to the types of asset under management in each AIF they manage:

- o For AIF which invest in liquid assets like shares or bonds: quarterly reporting

[31] This includes the principal markets and instruments in which it trades; the principal exposures and most important concentrations; arrangements for managing liquidity; the current risk profile of the AIF and the risk management systems employed; information on the main categories of assets in which the AIF invested; and the results of the stress tests.

- For AIF which invest exclusively in non-liquid assets like real estate or private equity: annual reporting.

It is relatively easy and not costly to report on trades in liquid assets, and it is much less likely that AIFs that invest in illiquid assets are potentially systemically important. Therefore the latter should not be obliged to report as frequently as AIFs that invest (also) in liquid assets. As the higher reporting frequency is already triggered when not all assets are illiquid, this option refers to individual AIFs and not to AIFMs.

<u>Option 4 (Level of activity)</u>: The reporting frequency would be determined by the investment activity of the AIF relative to the value of AuM of the AIF:

- For AIF for which the turnover is equal or greater than 100% of the value of the AuM per quarter the AIFM has to report quarterly;

- For AIF for which the half-yearly turnover is equal or greater than 100% of the value of the AuM the AIFM has to report semi-annually;

- For AIF for which the half-yearly turnover is lower than 100% of the value of the AuM the AIFM has to report annually.

The reasoning behind this option is that it would not be of great value to competent authorities to receive the same or almost the same data several times per year. Therefore, the reporting frequency should be determined by the activity profile of the AIF/AIFM. This criterion would indirectly take into account the types of assets as well.

<u>Option 5 (Size and investment type)</u>: Using only one criterion might not achieve the appropriate level of differentiation. It might be more appropriate to combine criteria. Firstly, the size in terms of AuM could be measured by AIF and by AIFM, secondly, the AIFMD pays particular attention to the treatment of funds investing in non-listed companies and issuers in order to acquire control.

(a) AIFM managing portfolios of AIFs whose AuM below the thresholds calculated in Article 3(2)(a) and (b) shall report on an annual basis;

(b) AIFM managing portfolios of AIFs whose AuM are above the thresholds calculated in Article 3(2)(a) and (b) but below €1bn shall report on a semi-annual basis; and

(c) AIFM managing portfolios of AIFs whose AuM are above €1bn shall report on a quarterly basis;

(d) for AIF whose AuM are greater than 500mn€ AIFM report on a quarterly basis in respect of that AIF.

By way of derogation from the above, AIFMs of unleveraged AIFs which in accordance with their core investment policy invest in non-listed companies and issuers in order to acquire control, will only have to report on an annual basis for these AIFs. This exemption is based on the fact that the AIFMD already takes the particular nature of such funds into account. This option is based on the combination of the ESMA's advice and regulatory reporting standards in a major non-EU AIFM jurisdiction. ESMA's thresholds have been defined on the basis of the assessment by national supervisors of the appropriate trade-off between their data requirements in order to comply with their duties under the AIFMD and the resulting administrative burden for them and the AIFM concerned. The threshold of €1bn is in line with the SEC rule under the Dodd-Franck Act requiring large AIFM (above USD 1.5bn in assets under management) to report quarterly.[32]

Analysis of impacts

Option 2 (No differentiation): Quarterly reporting on all AIF would be a simple rule but burden competent authorities with the task to 'digest' a vast amount of reporting even from small AIFM below the threshold which have opted in and manage AIF which do not trade much. This would go against the requirement of Art. 24 (6) AIFMD to avoid administrative burden on competent authorities and would even risk that the analysis and filing of rather irrelevant information would distract focus and resources of competent authorities from more important AIFM. As a result the quality of supervision could suffer with adverse impacts on systemic risk and market monitoring, and investor protection. It would also be difficult to find an appropriate filter in order to aggregate the information at EU level at ESMA or the ESRB. There again the risk might arise that relevant information go unnoticed.

Alternatively, the reporting frequency could be set at the maximum allowed by the AIFM Directive, namely annual reporting. While this would avoid the heavy administrative burden, the risk not to achieve the other objectives, macro-prudential supervision, market monitoring and investor protection, could not be achieve to a satisfactory extent, probably even to a lesser extent than at the moment.

Option 3 (Asset type) distinguishes between liquid assets which tend to be traded more frequently and illiquid assets for which buying and selling usually takes some time and involves considerable transaction costs so that these assets are not traded frequently. The advantages of this option would be that it could also reduce the administrative burden on AIFMs and competent authorities with respect to reporting and thereby the risk to miss important information. A shortcoming of this option is that the liquidity of assets seems to be only a proxy for the trading activity as liquid assets could be held for a longer period as well, i.e. this option might rightly exempt AIFs that are purely invested in illiquid assets from more frequent reporting obligations but would still capture AIFs that are (partially) invested in liquid assets without trading frequently. What is more, it would be difficult to determine exactly what a liquid asset is.

Option 4 (Level of activity) tries to address these shortcomings by focusing directly on the trading frequency of the AIF. No matter whether big or small, AIF that are very active would have to report more frequently in order to ensure that competent authorities have up-to-date information at hand. AIF without trading activity, on the other hand would not be forced to hand in the same information again and again. Authorities could focus on those funds and markets where there is significant activity. They could detect herd behaviour or concerted actions earlier. A disadvantage of this option is that it would require some additional effort by AIFM in order to track turnover and potentially to adjust their reporting frequency and by competent authorities to supervise this. Another drawback of this approach is that the level of activity is not fundamentally linked with the risk that the AIF may pose on the overall system. Small AIF could be seen as 'frequent traders' although their activity is negligible compared to the market as a whole. On the other hand, very big AIF could be regarded as not frequently trading and therefore report less frequently although because of the volumes they might already have significant impact on markets.

[32] CFTC and SEC: Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, available at http://www.sec.gov/rules/final/2011/ia-3308.pdf

Option 5 (size and investment type) establishes a clear link between size and risk; the bigger a fund the more likely it is that it might be systemically important individually or in combination with other financial players. The criterion of size is also used in banking law in order to determine SIFI (systemically important financial institutions). Two derogations from the general rule are foreseen. Firstly, even if the AIFM may be of small size it may manage AIF whose assets are above 500m, in this case the quarterly reporting requirement would apply to those AIF. Secondly, AIFM invested in non-listed companies might pose less risk to the financial system because the investments are not so sensible to market pressure; in this case annual reporting would be sufficient. This specific rule takes also the objective to keep administrative burden on competent authorities low into account.

The quarterly reporting threshold of €1.5bn would most probably be triggered by all bigger AIFM. It can be assumed, however, that they would have the necessary resources to comply with this requirement; they might even already report frequently. AIFM of a lower size which might be relatively more impacted by increased administrative burden would have to report on a less frequent basis. This staged approach should nevertheless ensure that competent authorities receive relevant information from all AIF at an appropriate frequency without imposing high administrative costs on them.

Impacts on stakeholders

The reporting frequency impacts directly on AIFM and their competent authorities. For both, administrative burden will increase with the reporting frequency. However, this increase will not be linear. The higher the frequency, the more reporting items might remain unchanged from one interval to the next. Costs would then be limited to checking the information and resubmitting it. The benefits of a higher, or rather appropriate, reporting frequency would be for investors or market participants at large in the form of lower risk of problems with a specific AIFM or in a market where AIFM are active as competent authorities could step in as soon as they see such problems arising. AIFM will be affected similarly across the board. Costs will generally increase with the trading frequency and the number and 'complexity' of the items in the reporting template on which the AIFM will have to report for the AIF under its management. As a general rule, these factors should off-set each other to some extent as funds that trade very frequently do this usually in standardised, listed financial instruments for which reporting is relatively straightforward and many of these funds will already have to do this at least at a quarterly basis already. Funds investing in assets for which reporting is more complex, e.g. private equity funds, usually do not trade frequently, as a consequence, these items of the reporting might stay unchanged for several quarters or even years.

Comparison of options

Option 2 (No differentiation) would be the easiest to monitor and to implement. This does not mean, however, that it would also be the most efficient one. Right to the contrary, it would oblige all AIFM to report quarterly no matter what their importance in terms of macro-prudential risks and market efficiency. Compared to the other options the only advantage would be its simplicity.

Option 3 (Asset type) introduces a differentiation but basing it on the type of asset would raise a number of practical problems and, most likely, legal uncertainty as it would require the development of a classification of assets. This would either be relatively expensive to establish, maintain and apply compared to the other options or would have to be defined relatively loosely and thereby give AIFM a high degree of discretion combined with legal uncertainty as competent authorities might contest individual assessments.

Option 4 (Level of activity) would have some advantage in this respect as trading volume and frequency, and thus turnover, are being recorded. However, as turnover might be relatively volatile for many funds, AIFM would be faced with a choice to either report at the highest frequency in order not to violate the obligation or to re-adjust the reporting frequency very often. Competent authorities would have to follow this closely. All in all, this monitoring might consume more time and resources than the actual reporting. If the reporting frequency would not have to be re-adjusted quickly there would be a risk that competent authorities do not receive information quickly on AIF which might pose a risk at the moment because their trading frequency was (exceptionally) low in the previous period.

Option 5 (size and investment_type) would not face these shortcomings as the fund size is in most cases more stable than the level of activity and does not face the definitional problems of option 3. It would ensure that all major AIFM were covered while small AIFM would not be overburden with reporting obligations. Compared to option 2, this option would lead to a certain reduction in the administrative burden for smaller AIFM and competent authorities. It would reduce the amount of information to be "digested" by competent authorities.

Therefore, option 5 is the preferred option.

Table 11: Reporting to competent authorities - comparison of options

	Effectiveness			Efficiency
	Macro-prudential supervision	Market efficiency	Investor protection	Limiting administrative burden
Option 1: no action	0	0	0	0
Option 2: No differentiation	-	-	-	--
Option 3: Asset type	+	+	+	-
Option 4: Level of activity	+	+	+	+
Option 5: Size and investment type	++	++	+	+

6.7. Issue 8: Employing leverage on a substantial basis

The notion of "*when leverage is to be considered to be employed on a substantial basis*" is crucial as it determines which AIFM will report on their use of leverage to the competent authorities. Supervisors need this information to assess whether AIF might contribute to the build-up of systemic risk in the financial markets or risks of disorderly markets. Specifying this notion at level 2 should ensure that all relevant AIFM are captured by this reporting requirement.

Three options have been identified to address this issue:

Option 1 (no action): 'No action' is not a viable alternative given the legal obligation for the Commission to adopt harmonising level 2 measures.

Option 2 (determination by the AIFM based on qualitative criteria): The measure would require the AIFM to self-assess whether an AIF it manages or markets in the EU employs leverage on a substantial basis based on a list of high level qualitative criteria such as the type of AIF, investment strategy, market conditions, whether the techniques employed could contribute to the aggravation or downward spiral in the price of financial instruments, or whether the use of leverage employed could contribute to the build-up of systemic risk or risk of disorderly markets. AIFM would be required to notify the competent authorities of the assessment so that the latter could review this assessment and possibly change this assessment.

Option 3 (quantitative threshold): Under this option, an AIF would be considered to be employing leverage on a substantial basis when its exposure, as calculated using the 'commitment method'[33], exceeded three times the net asset value (NAV) of the AIF.

Analysis of impacts

Option 2 would leave the determination of whether leverage is used on a substantial basis or not primarily to the AIFM, albeit subject to review by competent authorities. This option had been put forward in ESMA's technical advice arguing that the population of AIFs is very heterogeneous and therefore a single quantitative threshold might not do justice to all types of AIF and may not be appropriate to help competent authorities to identify systemic risk. This approach would require AIFM to determine the potential systemic relevance of the use of leverage by a particular AIF in isolation. Having to do such an assessment would be very demanding and would be very subjective.[34] Given the complexity and difficulty of this task, those costs can be expected to exceed any potential savings from lower reporting costs. Furthermore, it would create considerable legal uncertainty as to whether the AIFM has taken all relevant factors properly into account has come to the 'right' conclusion.[35]

Besides these potentially very high costs and legal uncertainty for AIFM there would also be relatively high costs on the side of competent authorities which would be obliged to review these assessments. The review of the qualitative assessment by competent authorities creates the risk of divergent approaches across competent authorities in the EU.

Furthermore, the subjective assessment bears a certain risk that AIFM of AIF which actually are substantially leveraged might not do this reporting because they have, deliberately or not, underestimated the importance of the leverage employed. Supervisors would, in turn, lack important information to assess potential build-ups of systemic risk.

Option 3 would establish a simple quantitative threshold. As the commitment method for the calculation of leverage provides a leverage figure that reflects the economic impact of an AIF, it seems appropriate to focus on AIF whose use of leverage needs to be monitored more in-depth in order to assess whether this fund, individually or together with others, might pose a risk for the functioning of certain markets or even the financial system as a whole.

The UCITS Directive's cap on leverage at 2xNAV is currently the only widely accepted threshold. However, as UCITS funds are generally suitable for retail investors, the rationale for this threshold is different: For UCITS the rationale is investor protection and the effect is a clear-cut limit on leverage, while for AIF the rationale is the monitoring of systemic risk and the functioning of the market. Also the UCITS threshold is an outright cap on leverage while in the AIFMD substantial use of leverage only triggers reporting obligations.

Respondents to the ESMA consultation nevertheless proposed that the 2xNAV threshold is also suitable to trigger additional reporting by AIFM. However, as many AIF follow investment strategies similar to those of UCITS, a threshold of 2xNAV would require reporting by a large number of AIF and would therefore represent additional administrative burden for the competent authorities. The additional burden might trigger little additional benefit - there would rather be a risk that competent authorities would be overwhelmed by the

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33 See section 6.3 for the discussion of the commitment method.

34 In fact, some of the criteria, e.g. contribution to downward spiral or systemic risk, cannot be usefully applied by their very nature from the perspective of an individual AIFM. They rather need to be applied in conjunction with activities of other AIFMs or even from the perspective of the whole market or market segment of one or more Member States which an individual AIFM cannot achieve.

35 The subjectivity and lack of clarity of this approach was also highlighted by a number of respondents to the ESMA consultation e.g. […]

amount of reports received and, in this way, increasing the risk of missing important information.

On the other hand, setting the threshold much higher (e.g. at 4x NAV) would risk casting the net too wide and no longer ensure an adequate level of leverage reporting and monitoring of systemic risk: Based on a sample out of 1,500 AIF in the UK, it is estimated that, when applying the commitment method, about one third is leveraged by a factor of two or more and about 15% are leveraged by a factor of four or more.

[…] estimates that the share is slightly higher for non-EU AIF, which are marketed in the UK or for which portfolio management is delegated to a UK entity, with around 20% being leveraged at more than 4xNAV.[36]

[…] estimates that the vast majority of open-ended German AIF is leveraged by less or 2xNAV (employing the commitment method) and hardly any German AIF would be leveraged by a factor of four or more, when the commitment method is applied.

In these circumstances, an intermediate ratio of 3xNAV seems an appropriate compromise which captures a significant number of AIF in order to ensure that supervisors can track the use of leverage by AIF which make substantial use of leverage and have access to a sufficiently large pool of leverage information to effectively monitor systemic and market risk without triggering reporting which does not provide any added value.

In any case, a quantitative threshold, would provide legal certainty for AIFM. Competent authorities would also benefit from a simple threshold because they would not need to review all the evidence that led the AIFM to its determination of whether it employs leverage on a substantial basis. Setting a reporting threshold would also not create a blind spot for the competent authorities. As regards the AIFs that would be below this threshold, competent authorities can get information about their levels of leverage in the annual reports of the AIFs.

Impacts on stakeholders

Competent authorities and AIFM would benefit from a clear and simple method determining when leverage is used on substantial basis. Proper monitoring of systemic risk and stability of financial markets by competent authorities would be impacted if the reporting trigger was not adequately determined. AIFM would also benefit from greater legal certainty.

Option 3 would not create any additional costs for AIFM as they have to calculate the leverage on the basis of the commitment method anyway. The cost of checking whether the leverage of an AIF is above or below 3 is negligible. In other words, while option 2 would cause considerable costs for all AIFM as they would have to regularly assess their use of leverage in the overall economic and specific market context, option 3 would therefore entail no costs at all for probably the majority of AIFM as their leverage will be below the threshold of three times NAV.

The costs associated with the additional reporting, i.e. the information to be reported, and potential further action by competent authorities are already set at level 1. The threshold only determines how many AIFM will have to report. As this decision is left entirely to the AIFM under option 2 it is not possible to say whether the number of AIFM considered to be using leverage on a substantial basis would be higher under option 2 or under option 3.

Comparison of options

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[36] It should be noted that these figures have been produced on an ad-hoc basis and that it was not possible to validate the sample selection or these figures in any way. Therefore they should rather be understood as rough estimates and not as a proper calculation.

Both AIFMs and competent authorities would benefit from the simple quantitative method of option 3 compared to the qualitative approach in option 2. The costs associated with the task to assess systemic risk implications of the use of leverage by an individual AIFM under option 2 are disproportionate in the context of establishing a simple reporting requirement, given that the costs of actual reporting are deemed negligible.

Option 3 appears superior with respect to efficiency. Given its simplicity, option 3 also achieves the objective of legal certainty. Setting the threshold of reporting at twice the NAV calculated using the commitment method would achieve reporting by AIFMs that employ higher levels of leverage while exempting AIFM of AIF whose leverage is similar to UCITS. Option 3 therefore achieves the objective of adequate reporting of leverage information to competent authorities and avoids creating excessive administrative burden. Based on the analysis above, Option 3 is the preferred option.

Table 12: Employing leverage on a substantial basis - comparison of options

	Effectiveness			Efficiency
	Macro-prudential supervision	Market efficiency/legal certainty	Investor protection	Limiting administrative burden of competent authorities
Option 1:no action	n.a.	n.a.	n.a.	n.a.
Option 2: determination by AIFM, qualitative criteria	+/0	+/0	+/0	0
Option 3: quantitative threshold	++	++	++	++

6.8. Overall impact of AIFMD level 2 measures

The AIFMD not only regulates managers of alternative investment funds for the first time at EU level but for many AIFM it is the first time that they will be regulated at all. Therefore, there is not much acquis on which the new regime can be based.

By being already very detailed in a number of technical aspects, AIFMD acknowledges the need that precise and detailed obligations are already enshrined in the 'basic' legislation itself. In this way the AIFMD acknowledges that it is the first measure making all types of investment fund subject to an adequate level of regulatory oversight at EU level. However, in order to ensure harmonised implementation of these rules, for a number of them additional technical specifications appeared necessary. The table in Annex 6 illustrates which problems and objectives the various level 2 measures predominantly address. Most focus on the objectives to address micro-prudential risks and to ensure or improve investor protection. However, there are also a number of measures which aim at monitoring and reducing macro-prudential risks and to improve market integration and efficiency.

It is also important not only to look at individual measures but also at their combined impact. For example there were claims from stakeholders that leverage calculated using the gross method would not provide useful information about the risk taken by an AIF (issue 2). However, if this information is seen in context with other information reported (issue 7) it allows supervisors (and sophisticated investors) to draw meaningful additional conclusions regarding the risk in the fund, its exposure and its position in and potential impact on markets.

Summing up, by ensuring a harmonised implementation and application of the AIFMD the level 2 measures will make sure that the objectives of the level 1 Directives can be achieved without imposing inordinate additional burden on stakeholders. This includes the sometimes claimed risk of relocation or off-shoring of EU AIFM as a reaction to the AIFMD. During the negotiation on the level 1 Directive the fund industry has repeatedly threated that there would be a mass exodus of AIFM from the EU to third countries if the AIFMD would ever be adopted. However, so far it seems that it rather attracts business instead of forcing it to leave the Union. This means the benefits of the Directive seem to outweigh the costs by far. Similar claims have again been made during the discussion of the level 2 measures. Yet, all in all, the industry seemed to be quite satisfied with the technical advice by ESMA. The preferred options of this impact assessment in most cases do not deviate significantly from this advice, in some cases they should even lead to a lower burden on AIFM, e.g. with regard to additional own funds/PII (issue 3) or the calculation/assessment of whether leverage is being used on a substantial basis (issue 8). It is therefore not to be expected that any of these issues would trigger an AIFM to relocate outside the Union. The clear rules might rather convince more managers to move business onshore in order to benefit from the regulatory regime.

There should also be a beneficial effect on institutional investors, such as pension funds or insurances, and thereby a positive social impact. The proper regulation of AIF in the Union will help investors in their due diligence before investing in AIF but will also provide some reassurance while staying invested as they will be provided with more and more standardised information by the AIFM and can rely on CA ensuring compliance with the AIFMD. Furthermore, better control of systemic risks and market risks through CA should reduce such risks to the benefit to all.

7. CHOICE OF LEGAL INSTRUMENT FOR ALL LEVEL 2 MEASURES

The main aim of the level 2 measures is to specify provisions in the AIFMD in order to ensure consistent implementation and application of the Directive across all Member States. This is important in order to ensure that the objectives of the Directive can be achieved. The best legal instrument to ensure such consistency is a regulation. A regulation, as part of a single rulebook, guarantees full harmonisation and provides AIFM, professional investors and other stakeholders with full legal certainty and ensures full market integration. The implementation by means of a Directive, on the other hand, would either leave some uncertainty for players and would risk that objectives like macro-prudential oversight or improved investor protection could not be fully achieved or be a misnomer in the sense that its provisions were that strict that no flexibility would be left to Member States to make own adjustments.

8. MONITORING AND EVALUATION

The lack of quantitative information about the AIF and AIFM sector reflects to some extent the lack of regulation till now. The implementation of the AIFMD, in particular the disclosure and reporting requirements of Articles 3, 7, 22, 23 and 24, should in a way solve this problem. Therefore, the situation should be much better in this regard at the time of the three evaluations mentioned below as ESMA and the Commission should benefit from the data collected by national competent authorities, ESMA and the ESRB. Such data would cover both AIFM that fall below and AIFM that are above the thresholds of Article 3.

By implementing harmonised rules and a passport for third country entities in a sector that was under no or very diverse forms of regulation so far the AIFMD represents nothing less than a revolution to this sector. It will therefore be necessary to monitor permanently the effects of the Directive from the very beginning until all elements of it are in place and it is ensured that everything works smoothly without adverse impacts on specific stakeholders.

The following indicators could be used with regard to the respective objectives:

- Monitoring of macro-prudential risks: Crisis events triggered by AIFM covered by the AIFMD;
- Supervision of players: Number of EU and non-EU AIFM authorised, number of and value assets under management by AIF managed by them;
- Market efficiency: With regard to efficiency of financial markets: Development of transaction costs, number and severity of market failures triggered by AIFM; with regard to efficiency of AIF markets: number of AIFM and AIF covered by the Directive, assets under management by these AIF, Relocation of AIFM into or out of the Union as a reaction to the Directive.
- Enhanced management of micro-prudential risks in and by AIF and investor protection: Losses (number of events and aggregate amount) occurred by AIF due to operational failures by AIFM or depositaries;

In addition to this monitoring, the final provisions of the Directive already establish a thorough evaluation programme by requiring analyses of the impacts of (parts of) the Directive at crucial points in time:

- In the context of the implementation of a passport for third country AIF and AIFM, Article 67 requires ESMA to present by July 2015 an analysis of problems regarding, inter alia, the effective cooperation among competent authorities, the effective functioning of the notification system, and investor protection, and of the effectiveness of the collection and sharing of information in relation to the monitoring of systemic risks by national competent authorities, ESMA and ESRB.
- Three years after the potential implementation of this passport, Article 68 requires ESMA to present an analysis of the same issues and a number of additional ones, including the use made of the passport, the investor access in the Union, the negotiation, conclusion, existence and effectiveness of the required cooperation arrangements, and the potential market disruptions and distortions in competition (level playing field) and any potential negative effect on investor access or investment in or for the benefit of developing countries.
- Article 69, finally, requires the Commission to start a comprehensive review on the application and the scope of this Directive by 22 July 2017. This review should be based on public consultation and discussions with competent authorities.

Conformity check, transposition and implementation planning

The subject of this proposal/impact assessment consists of delegated and implementing measures to the Alternative Investment Fund Managers Directive (2011/61/EU) due to enter into force in July 2013. These are so-called Level 2 measures that specify details of the Level 1 Directive. They will take the form of regulations and will therefore contain detailed requirements that will leave Member States little or no latitude for interpretation. They are directly applicable and should not be implemented at national level. Furthermore, the regulations (at least at their current drafting stage) do not envisage requiring Member States to adopt supporting measures. Hence, there is no need for a transposition/implementation plan. For the same reasons a conformity check is not necessary in the case of Level 2 regulations.

However, as part of the implementation of the level 1 Directive, the Commission has asked Member States to designate contact persons for transposition purposes. Together with

Commission staff in charge of the file, the designated contact persons form the so-called transposition network for the AIFMD. So far, only bilateral contacts have taken place and informal comments have been exchanged, but it is envisaged that a transposition workshop will be organised before the implementation deadline. The transposition network may also be used for the exchange of information regarding the concrete application of Level 2 measures.

9. ANNEXES

Annex 1: Glossary

Alternative Investment Fund (AIF): is a legal structure to pool assets and hold investments. It usually has no economic life on its own; the key decisions in relation to the management and marketing of AIF are taken by the AIFM. AIF span a wide range of legal structures, including closed and open-end funds and partnerships.

Alternative Investment Fund Manager (AIFM): is responsible for the management of investment portfolios of AIF. Typical tasks include, for example, the provision of internal governance structures, risk management, the delegation of functions to third parties and relations with investors.

Assets under management: value of assets that an investment company manages on behalf of investors.

Central counterparty: an entity that interposes itself, in one or more markets, between counterparties of contracts traded, becoming the buyer to every seller and the seller to every buyer and thereby guaranteeing the performance of open contracts.

Centralized securities depository: an entity that
1) enables securities transactions to be processed and settled by book entry
2) provides custodial services (e.g. the administration of corporate actions and redemptions)
3) plays an active role in ensuring the integrity of securities issues
Securities can be held in a physical (but immobilised) form or in a dematerialized form (whereby they exist only as electronic records)

Closed-ended fund: is a collective investment scheme with a limited number of shares. Once the fund is launched, new shares are rarely issued. Existing shares are exchanged on a secondary market directly between investors. Selling shares in some types of closed-ended fund, like private equity, often requires consent of the fund manager.

Collateral: an asset or third party commitment that is used by the collateral provider to secure an obligation to the collateral taker. Collateral arrangements may take different legal forms; collateral may be obtained using the method of title transfer or pledge.

Collateral management: granting, verifying, and giving advice on collateral transactions in order to reduce credit risk in unsecured financial transactions.

Competent authority: Any organization that has the legally delegated or invested authority, capacity, or power to perform a designated function. In the context of AIFMD, it refers to the body which is in charge of supervising securities markets.

Corporate action: an action or event decided by the issuer of a security which has an impact on the holders of that security. This may be optional, in which case those holders have a choice (e.g. they may have the right to purchase more shares, subject to conditions specified by the issuer). Alternatively it may be mandatory, whereby those holders have no choice (e.g. dividend payment). Corporate actions can relate to cash payments or the registration of rights.

Custodian: an entity, often a credit institution, which acts as "account provider" and provides securities custody services to its customers, i.e. holding and administration of securities owned by a third party.

Depositary: a credit institution that keeps assets or securities on behalf of a client, e.g. an AIF. The depositary has two primary functions: to safekeep the AIF's assets and to oversee its compliance with the AIF rules and with applicable laws and regulations.

Derivative: A derivative is a type of financial instrument whose value is based on the change in value of an underlying asset.

ESMA: The European Securities and Markets Authority is the successor body to CESR, continuing work in the securities and markets area as an independent agency and also with the other two former level three committees. http://www.esma.europa.eu

ESRB: The European Systemic Risk Board is part of the European System of Financial Supervision (ESFS), the purpose of which is to ensure supervision of the Union's financial system. It is responsible for the macro-prudential oversight of the financial system within the Union in order to contribute to the prevention or mitigation of systemic risks to financial stability in the Union that arise from developments within the financial system and taking into account macro-economic developments, so as to avoid periods of widespread financial distress. http://www.esrb.europa.eu

Exposure: the extent to which an AIF is vulnerable to changes in a given financial market

Financial instruments account: an account dedicated to record and hold the financial instruments traded by the account's holder.

Gross exposure: is the exposure based on the absolute value of all positions, assets and liabilities, held by the AIF in financial instruments. The gross exposure of derivative instrument consists of the equivalent position in the underlying asset.

Hedging arrangement: combinations of trades on derivative instruments and/or security positions which do not necessarily refer to the same underlying asset and where those trades on derivative instruments and/or security positions are concluded with the sole aim of offsetting risks linked to positions taken through the other derivative instruments and/or security positions.

Issue: depending of the context, this term may cover either the decision of the issuer to issue securities and to start the relevant issuance procedure as imposed by corporate law (in particular registration) or the entering of securities in book entry form in a Central Securities Depository.

Issuer: the issuer of a security

Leverage: is a general term for any technique to multiply gains and losses. Leverage can be generated by borrowed money that a fund employs to increase buying or selling power and increase its exposure to an investment or by using derivative instruments that embed already leverage. It is expressed as a ratio between the exposure of an AIF and its Net Asset Value

Liability: an entity's legal debts or obligations that arise during the course of business operations. Recorded like asset and equity on the balance sheet, liabilities include loans, mortgages or any duty that entails settlement by future transfer.

Mark-to-market: accounting for the fair value of an asset or liability based on the current market price of the asset or liability.

Money market instrument: class of assets represented by very short-term debt securities (debt that normally matures in less than one year). Money market investments are also called cash investments because of their short maturities, and their near-liquid nature (almost immediate access upon request).

Net Asset Value: value of a fund's total assets, minus its liabilities. The NAV per share is used to determine prices available to investors for redemptions and subscriptions.

Netting arrangement: combinations of trades on derivative instruments and/or security positions which refer to the same underlying asset, irrespective – in the case of derivative instruments – of the contracts' due date and where those trades on derivative instruments and/or security positions are concluded with the sole aim of eliminating the risks linked to positions taken through the other financial derivative instruments and/or security positions.

Non-linear investment strategy: consists of following strategies aimed at taking advantage of market inefficiencies and relative pricing discrepancies. It is opposed to the directional investing which consists of being long or short in order to follow the market trend.

Non-listed company: A company whose shares are not on the official list of shares traded on a particular stock market.

Offsetting: means combinations of trades on derivative instruments and/or security positions which do not necessarily refer to the same underlying asset and where those trades on derivative instruments and/or security positions are concluded with the aim of offsetting risks linked to positions taken through the other derivative instruments and/or security positions. Offsetting arrangements may include combinations of trades which aim to generate a return.

Open-ended fund: is a collective investment scheme which can issue and redeem shares at any time. Investors can buy or sell shares directly from the fund.

Option: An option is an agreement that gives the buyer, who pays a fee (premium), the right, but not the obligation, to buy or sell a specified amount of an underlying asset at an agreed upon price (strike or exercise price) on or until the expiration of the contract (expiry). A call option is an option to buy, and a put option an option to sell.

Over The Counter (OTC): OTC trading is a method of trading that does not take place on an organised venue like a regulated market. It can take various shapes from bilateral trading to trading done via more organised arrangements (such as systematic 'internalisers' and broker networks).

Pledge: placing of owned property by a debtor (the pledger) to a creditor (the pledgee) as a security for a loan or obligation. The pledgee has an implied right to confiscate and/or sell the pledged property to satisfy his or her claim in case of a default.

Principle of proportionality: Similarly to the principle of subsidiarity, the principle of proportionality regulates the exercise of powers by the European Union. It seeks to set actions taken by the institutions of the Union within specified bounds. Under this rule, the involvement of the institutions must be limited to what is necessary to achieve the objectives of the Treaties. In other words, the content and form of the action must be in keeping with the aim pursued. The principle of proportionality is laid down in Article 5 of the Treaty on European Union. The criteria for applying it is set out in the Protocol (No2) on the application of the principles of subsidiarity and proportionality annexed to the Treaties.

Private equity: equity capital that is not quoted on a public exchange. Private equity consists of investors and funds that make investments directly into non-listed companies or conduct buyouts of public companies that result in a delisting of public equity. The majority of private equity consists of institutional investors and accredited investors who can commit large sums of money for long periods of time

Re-hypothecation: is a practice that occurs principally in the financial markets, where a bank or other broker-dealer reuses the collateral pledged by its clients as collateral for its own borrowing.

Reconciliation (trade settlement): a process used to compare two sets of records to ensure the figures are in agreement and are accurate. Reconciliation is the key process used to determine whether the money leaving an account matches the amount spent (e.g. for buying a financial instrument), ensuring that the two values are balanced.

Redemption (of units, shares): the return of an investor's principal in a fixed income security, such as bonds, or the sale of units in an investment fund. Redemption occurs upon maturity for a fixed income security and at the choice of the investor in the case of investment funds.

Repurchase agreement (repo): This transaction occurs where an AIF sells securities to a counterparty and agrees to buy them back at an agreed price in the future. The repurchase price should be greater than the original sale price, the difference effectively representing interest, sometimes called the repo rate. The party that originally buys the securities effectively acts as a lender and the original seller is effectively acting as a borrower, using their security as collateral.

Safekeeping: the keeping of assets by a financial institution; the act of holding client's securities or other assets on its behalf.

Segregation: a method of protecting a client's assets by holding them separately from those of the custodian (or other clients, as the case may be).

Settlement: the completion of a transaction or of processing with the aim of discharging participants' obligations through the transfer of funds and/or securities. A settlement may be final or provisional.

Shares (bearer form): are made out to an unnamed bearer. In contrast to the case of registered shares, the company does not know who owns its shares. Bearer shares can be transferred both on-exchange or over-the-counter and the owner still acquires membership and proprietary rights on buying the shares. The banks who have handled the purchase of the shares know the names and addresses of the persons purchasing the bearer shares. They provide the shareholders with their confirmation of share ownership for the general meeting of shareholders and receive dividend payments on their behalf.

Shares (nominative form): also called registered shares. Holders of registered shares are always recorded in the share register of the given company, thus the company knows their name, birth date, address and number of shares they own. As a result, the company has an overview of the ownership proportions and it is easier to get in contact with the shareholders. As soon as an investor acquires registered shares, his/her bank is obligated to provide the company immediately with the particulars of the new shareholder.

Sub-custodian: any company/institution providing custody administration services on behalf of other custodians who may not have an operation in the country concerned.

Subscription (of units, shares): the act for an investor to agree or at least state his or her intent to buy prior to the issue date a newly issued security. It can be considered as an order to purchase soon-to-be-issued shares or units.

Systematic internaliser: are investment firms which, on an organised, frequent and systematic basis, deal on own account by executing client orders outside a regulated market.

Systemic risk: the risk that the inability of one participant to meet its obligations in a system will cause other participants to be unable to meet their obligations when they become due, potentially with spill over effects (e.g. significant liquidity or credit problems) threatening the stability of or confidence in the financial system. That inability to meet obligations can be caused by operational or financial problems.

Title transfer (for collateral): arrangement under which a collateral provider transfers full ownership of, or full entitlement to, financial collateral to a collateral taker for the purpose of securing or otherwise covering the performance of relevant financial obligations.

Transferable security: means classes of securities which are negotiable on the capital market with the exception of instruments of payment.

Turnover: measures the frequency at which the assets are replaced in a fund's portfolio.

UCITS: Undertakings for Collective Investment in Transferable Securities Directives, a standardised and regulated type of asset pooling.

Underlying asset: is a term used in derivatives trading, such as with options. A derivative is a financial instrument whose price is based (derived) from a different asset. The underlying asset is the financial instrument (e.g., stock, futures, commodity, currency or index) on which a derivative's price is based.

Value at Risk (VaR): is a risk measure of the risk of loss on a specific portfolio of financial assets. It is the maximum loss a portfolio could face over a given time horizon at a given probability level.

Annex 2: Short description of the AIFMD and timetable of the level 2 work

1. The Framework Directive

In April 2009, the European Commission proposed a Directive on Alternative Investment Fund Managers[37] (AIFMD) as part of its goal to extend appropriate regulation and oversight to all actors and activities that embed significant risks in the financial sector.

The proposal and the Directive as finally adopted by Council and European Parliament entered into force on 22 July 2011. It introduces for the first time in the Union harmonised requirements for entities engaged in the management and administration of alternative investment funds (AIF).

Up to now, AIFM are regulated at national level only, if at all. This means that with the implementation of AIFMD a number of AIFM will be regulated for the very first time. National regulation differed significantly across Member States and types of AIF.[38]

The AIFMD regulates the managers of alternative investment funds, above a certain de minimis threshold, managing or marketing AIF in the Union. This broad scope includes all fund managers except those of so-called UCITS funds which were already regulated under Directive 2009/65/EC (Recast of the Directive 85/611/EEC). A second limitation of the scope is that the Directive regulates only the marketing of AIF to professional investors as defined in Directive 2004/39/EC (MiFID). The marketing of AIF to retail investors and the sale of units or share on the initiative of the investor are not covered by the AIFMD. It is left to national regulators in Member States to decide on the regulation of the marketing of AIF to retail investors. The AIFMD, however, sets minimum requirements in this respect. The AIFMD does, however, cover the marketing of AIF established in third countries to professional investors in the Union as well as the management of AIF established in the Union, even if they are not marketed to investors in the Union.

This means that the AIFMD covers all kinds of AIF/AIFM ranging from simple equity funds which could in principle also seek authorisation under UCITS, to funds investing in specific, illiquid assets like real estate, private equity, infrastructure, commodities or goods like wine or art. It covers all possible investment strategies, legal forms and open- as well as closed-ended funds.

There are a number of crucial differences between the regulatory regimes in the AIFMD and the UCITS Directive. Firstly, it is important to note that, in contrast to the UCITS Directive, the AIFMD is not a voluntary regime. Any fund managed or marketed in the Union which is not a UCITS fund will have to be managed by an AIFM. Secondly, the AIFMD provides market access for non-EU AIFM while UCITS have to be established in the Union. Thirdly, the AIFMD only provides the right to market AIF to professional investors in the Union, while UCITS can be marketed publicly, i.e. to retail investors as well. Fourthly, the AIFMD does not impose requirements directly on the fund but on the manager, and the depositary. UCITS on the other hand contains detailed provisions with regard to what UCITS are allowed

[37] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:0073:EN:PDF

[38] For an overview of differences in national regulation of open ended real estate funds see the report of an expert group appointed by the European Commission: http://ec.europa.eu/internal_market/investment/real_ estate_ funds_en.htm #report; and similarly for Alternative Investment Funds (Hedge Funds and Private Equity): http://ec.europa.eu/internal_market/investment/alternative_investments_en.htm#alternative

to do and what not. This covers issues such as diversification requirements (in principle, UCITS are not allowed to invest more than ten per cent of their assets in one specific asset), limitations on the types of assets the fund might invest in (only transferable securities, not in, e.g. real estate, private equity or commodities), or the obligation to redeem units upon request on short notice. Such limitations did not seem appropriate for professional investors.

The AIFMD grants AIFM authorised under the Directive the right to manage and market AIF to professional investors in the Union. This means that, once authorised, an AIFM can manage AIF in any Member State (MS) and market AIF in any MS and across borders.

In order to obtain and retain authorisation the AIFM has to comply with the requirements of the Directive which range from:

- capital requirements,
- operating conditions,
- risk and liquidity management to
- organisational requirements,
- rules on delegation of tasks,
- the appointment of a depositary that, in turn, has to comply with strict rules, to
- rules regarding disclosure to investors and
- reporting to competent authorities.

In addition, there are dedicated chapters with specific requirements for AIFM of leveraged AIF (chapter V, section 1), for AIFM managing AIF which acquire control of non-listed companies and issuers (chapter V, section 2), for AIFM established outside the Union marketing or managing AIF in the Union (chapter VII), and for AIFM managing AIF established outside the Union (chapter VII).

2. Limitations of available policy options

The AIFMD is already relatively prescriptive and detailed for a level 1 framework Directive. This limits the scope for the design of options in the impact assessment and policy making considerably. At the same time does this great level of detail of the AIFMD already trigger most of the aggregate impacts of the combined level 1 and level 2 legal texts.

With respect to the issues discussed in this IA this means that the AIFMD already requires AIFM to calculate the assets under their management (issue 1) and the leverage they employ (issue 2). Level 2 only specifies the concrete approach(es) to be followed.

Similarly, the AIFMD already requires AIFM to have additional own funds or to hold a PII (issue 3). Here, however, considerable discretion is left to level 2 in specifying the amounts or coverage to be held.

The requirements to hold in custody financial instruments owned by the AIF (issue 4), the definition of "external event" (issue 5) and the scope of cash monitoring (issue 6), on the other hand, do not provide for much scope, at least in the light of the level 1 text and other existing legislation.

The AIFMD requires AIFM to report to competent authorities (issue 7) at least at an annual basis and therefore sets a relatively narrow frame for reasonable reporting intervals.

The AIFMD leaves considerable scope for policy options as to when AIFM are to be considered as employing leverage on a substantial basis (issue 8) as it does not give any indication of what could or should be considered as a substantial use of leverage.

3. (Indicative) Timetable for AIFMD Level 2 work

Date	Milestones
December 2010	Commission request for advice to CESR Launch of call for evidence on the request by CESR
January 2011	ESMA Open hearing on Commission mandate
April 2011	Public consultation by Task Force 1 Workshops by Task Forces
May 2011	Workshops by Task Forces
July 2011	AIFMD level 1 published in Official Journal, entry into force 21 July 2011 ESMA consultation on draft technical advice (16/07 till 16/09)
August 2011	ESMA consultation on supervision chapter (16/08 till 16/09)
September 2011	ESMA hearings on the two consultation documents
November 2011	Submission of ESMA advice to European Commission
February 2012	Submission of IA report to IAB
March 2012	IAB meeting
May 2012	Launch ISC
June 2012	*Translation*
July 2012	*Adoption of L2 measures by the College*
October 2012	*End of period for EP and Council to object to Level 2 measures,* *MS start implementation of Level 2 Directives*
July 2013	*AIFMD Level 1 and 2 taking effect*

Annex 3: Background on the AIF sector, risks AIF might pose

The alternative investment funds sector

Since the entry into force of the AIFMD, all investment funds in the EU fall into one of the following two categories: They are either UCITS (undertakings for collective investment in transferable securities) or AIF. UCITS funds are those that comply with harmonised rules as laid down in the UCITS Directive (2009/65/EC) and are authorised for sale to the retail market. They are not the subject of this IA report.

With almost 6trn€ of assets under management in the EU the UCITS fund sector is much more important than the AIF sector which nevertheless manages assets worth almost 2.2trn€ (end September 2011). The assets under management by AIF compare nevertheless to 18% of the EU's GDP or more than the GDP of France or the United Kingdom in the year 2010. While UCITS are mainly sold to retail investors, more than two thirds (68%) of the assets of AIF are held by institutional investors, 70 per cent of which are comprised of pension funds and insurance companies.[39]

AIF are defined in the AIFMD as "collective investment undertakings, including investment compartments thereof, which (i) raise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors; and (ii) do not require authorisation pursuant to Article 5 of Directive 2009/65/EC".

AIF do not form a homogenous class of investment fund. AIF invest in a wide variety of asset types and employ very different investment strategies. Inter alia, hedge funds, private equity funds, infrastructure funds, commodity funds and real estate funds can all be classed as AIF. 'Special funds' or 'institutional funds', which exist in many Member States and take various legal forms but are not limited to a specific asset class or investment strategy and can therefore not be attributed to a particular fund type, can also be included in this category.

It is furthermore important to note that many AIF are managed by external managers, which does not have to be established in the same jurisdiction, or even continent, as the AIF itself. This holds in particular for hedge funds, where the manager might be based in an EU jurisdiction while the fund is domiciled in, say, the Cayman Islands, to name a typical case. As available statistics, however, refer to the domicile of the AIF, they have to be treated with caution when concluding from fund data to AIFM.

4. Description of risks AIF might potentially pose or face

- **Systemic risks**

AIF may cause systemic risks through two broad channels:

'Credit channel': exposures to funds are an important source of counterparty risk for the providers of leverage, namely the prime brokers. These exposures are subject to prudential rules and are typically fully collateralised. However, risk management failures are possible, particularly if a fund borrows from multiple prime brokers and hence individual lenders may not have a global picture of a fund's leverage.

'Market channel': as large players in markets for many financial assets, leveraged funds have the potential to move markets, in particular in the event of the herding of positions in common trades. This

[39] Client Type in Total AuM (end 2009): Retail 32%, Institutional 68% (of which Pension Funds 25%, Insurance Companies 45%. Banks 4%, Other Institutionals 27%), EFAMA, Asset Management in Europe Facts and Figures 4th annual review, May 2011

is of particular concern in stressed conditions, where the disorderly unwinding of large, similar positions may fuel the collapse of asset prices and market illiquidity. This was seen in the beginning of the financial crisis in 2007-2008, where a vicious spiral was created: falling asset prices caused prime brokers to tighten lending conditions, forcing leveraged funds to sell assets, which in turn pushed prices down further.

In both cases, the risk is a function of the degree of leverage employed, since this will amplify the scale of both returns and losses. Within the universe of institutional funds, the use of leverage varies vary considerably and is on average considerably less than in some other financial sectors. Since the beginning of the crisis many funds that initially had a high leverage ratio have been forced by market conditions to reduce it in various ways.

- **Micro-prudential risks**

Investment funds are exposed to a large number of risks which can be categorized into 5 parts: market, credit, settlement, liquidity and operational risks. If one of these risks may materialize, this would impact grandly the viability of the fund itself and could also have an impact on business partners of the fund and even the financial system as a whole. Fund managers have an influence on the importance of some risks because their investment decisions directly impact their exposition to these situations. But in some cases this influence might be limited, especially under stressed market conditions.

Market risks

Fund managers take positions in the market by buying or selling assets. As soon as the prices of the assets follow an opposite direction as expected by the manager, the fund may be exposed to losses. The price swings are caused by many factors, e.g. market sentiment, economic fundamentals, interest rates, exchange rates… The magnitude of the losses depends of the nature of the assets and the overall exposition of the fund.

Market risk by asset

Not all assets have the same degree of risk. The volatility (a measure of the extent of the variation of a price) is one indicator to assess risk. The price of an asset with a low volatility tends to move less extreme than the one of an asset with a high volatility. Typically the stock of a small innovative company will show a higher volatility than the stock of a long time established and large company and thus may cause greater losses. Bonds are particularly exposed to movements in interest rates and the credit quality of the issuer. As soon as interest rates rise, the bond price will fall and if the credit quality of the issuer diminishes the bond price will also fall. Other types of asset like commodities or derivatives are subject to many other factors.

Market risk by global exposure

A fund may be invested in different assets with different degrees and directions, therefore the losses in one asset may be compensated by the gains in another asset. For example, if we consider a portfolio of bonds and derivative instruments providing opposite movements than the interest rates of the bonds, the fund may have limited its risk in case of a rise in interest rates (example of a hedge). The risk in such cases must be assessed globally and in relation to all assets in the portfolio.

Credit risk

Credit risk is mainly present when a transaction is realized over the counter (OTC) between two parties. There is a risk for each party that the counterparty might default, i.e. be unable to fulfil its obligations like making a promised payment or returning a borrowed asset to the other counterparty. This may happen, for example, when an AIF buys an option on a stock from an option seller. The option seller must at the expiry of the contract deliver the return (if any) of the option to the AIF. If the option seller is unable to meet its obligations, the AIF is fully exposed to that loss and won't receive what it is entitled to.

Settlement risk

This risk is also mainly present in OTC transactions. When two counterparties enter into a transaction they agree to pay, respectively deliver what they have bought or sold at a future date. This settlement period can range from one day to some weeks after the transaction date. The settlement process entails many risks, e.g. loss of assets, mismatching between the orders or default of the broker involved in the transaction. It happens also sometimes that a seller of a security is unable to deliver it to the buyer, for example in cases of naked short selling. The buyer must in this case wait till the seller is able to deliver or forced to deliver.

Liquidity risk

Funding liquidity risk

Many AIFs borrow money to buy assets in order to pursue certain strategies or to amplify the returns they generate. This process participates at the creation of leverage. Since borrowing money is not costless, AIFs have to pay interest rates and redeem the capital at the end of the borrowing period. There is a risk for the AIF that the access to fresh capital to finance its acquisitions may be reduced or stopped altogether. The AIF would then have to renew its borrowing arrangements, at the risk that these new conditions may be more, even prohibitively, expensive. The AIF would then be forced to sell assets to redeem the borrowed capital.

Market liquidity risk

Not all assets have the same liquidity in the market; that is the same availablity at a certain time and at a reasonable price. Typically high capitalized stocks have a large liquidity enabling investors to buy or sell the desired volume at a reasonable price. But other assets like less capitalized stocks or bonds may have a lower liquidity. In this case there is a risk that it cannot be purchased or sold without a significant concession in price because the market is unable to accommodate the desired trading size. For example if an AIF wants to sell 10'000 units of a bond and the regular daily trading volume on that bond is only 1'000 units. There is important risk that selling these 10'000 units in a few days may provoke a crash in the price of the bond. The AIF would then either have to bear the risk of a considerable reduction in the price or to spread the sale of the bond over a longer period of time than it intended.

Operational risks

The business of AIFMs involve many operational risks, this is mainly due to the fact that they operate in a complex environment that requires continuous monitoring of their systems and procedures. The risk of loss may be directly linked to a lack of control, to mistakes or fraudulent activities of the personal, to a break down of internal systems like the IT or simply to external factors like flooding or fire. Several major financial service suppliers have, inrecent years, incurred considerable losses on account of operational risks materialising. Many of these cases were linked to a lack of effective internal controls that permitted fraudulent activities of a trader.

- **Investor protection**

Lack of transparency

It is commonly assumed that these investors have the capacity to understand and to bear the risks that their investments entail. The experience of the financial crisis is a challenge to this assumption. The manifest failure of due diligence in some cases has fuelled doubt over the transparency of some investment vehicles vis-à-vis their investors, as well as the capacity and willingness of investors to process the information and to react accordingly.

In the course of the financial crisis concerns mounted that professional investors did not apply sufficient due diligence and did not have sufficient information to properly assess and manage their investments but either relied on external ratings or trusted and followed the trend.[40] A possible reason for this might be that investors did not get sufficient information from the fund managers and did not have sufficient bargaining power to force them to provide it. The logical consequence, namely to exit

[40] A study by EDHEC finds that there are 'great differences between hedge fund managers' perceptions of relevant information disclosure and their investors' needs suggest that the industry should rethink its overall disclosure practices.' Hedge Fund Reporting Survey, November 2008

the fund, however, might be understood as a sign of weakness or incompetence while staying in the fund did not raise any doubt and seemed to be of low risk – other investors would certainly apply due diligence and thereby ensure proper management of the fund.

Conflict of interest and fund governance

The relative opacity of many institutional fund structures and the absence of a prescriptive regulatory framework raise concerns over the oversight of internal processes. Fair treatment of the investor requires that processes such as valuation and administration are conducted prudently and fairly; and that any conflicts of interest are managed effectively. Investors also rely on fund managers to ensure that their assets are held safely in custody. The valuation process can be beset by conflicts of interest, in particular when the remuneration of the fund manager is driven by the performance of the fund. This may create an incentive to inflate the value of the fund's assets. This is a particular risk when the fund is highly leveraged or when assets are hard-to-value and/or infrequently traded, since the valuations are then difficult to verify.

- **Market efficiency and integrity**

Experience in the recent stressed market conditions has raised a number of concerns about the impact of funds, particularly hedge funds, on the efficiency and integrity of financial markets. Abusive practices and market manipulation are illegal. However, it seems that current rules did not provide sufficient basis for effective corrective action. To the extent that there is substance to these allegations, this is primarily a matter of improving monitoring and enforcement.

Annex 4: List of implementing and delegated acts

	Article	Area	Description
1	Art. 3(5)	Exemptions	Procedures for AIFM which choose to opt-in under this Directive
2	Art. 3(6)	Exemptions	Calculation of thresholds and treatment of AIFM whose AuM occasionally exceed and/or fall below the relevant threshold
3	Art. 3(6)	Exemptions	Obligations to register and to provide information to effectively monitor systemic risk
4	Art. 3(6)	Exemptions	Obligations to notify CA
5	Art. 4(3)	Definitions	Methods of leverage
6	Art. 4(3)	Definitions	How leverage shall be calculated
7	Art. 9(9)	Initial capital and own funds	Risks additional own funds or professional indemnity insurance must cover
8	Art. 9(9)	Initial capital and own funds	Conditions for determining appropriateness of additional own funds or coverage of the professional indemnity insurance
9	Art. 9(9)	Initial capital and own funds	Manner of determining ongoing adjustments of additional own funds or of coverage of professional indemnity insurance
10	Art. 12(3)	General principles (operating conditions)	Criteria to assess whether AIFM comply with their obligations
11	Art. 14(4)	Conflicts of interest	Types of conflicts of interests
12	Art. 14(4)	Conflicts of interest	Reasonable steps AIFM are expected to take in terms of internal and organizational procedures regarding conflicts of interest.
13	Art. 15(5)	Risk management	Risk management systems to be employed by AIFM
14	Art. 15(5)	Risk management	Appropriate frequency of review of risk management systems
15	Art. 15(5)	Risk management	How risk management function shall be functionally and hierarchically separated from operating units
16	Art. 15(5)	Risk management	Specific safeguards against conflicts of interest
17	Art. 15(5)	Risk management	Requirements regarding due diligence, ongoing risk monitoring, appropriateness of risk profile
18	Art. 16(3)	Liquidity management	Liquidity management systems and procedures
19	Art. 16(3)	Liquidity management	Alignment of investment strategy, liquidity profile and redemption policy
20	Art. 17	Investment in securitisation positions	Requirements to be met by originator in order for AIFM to be allowed to invest in securities or other financial instruments of this type issued after 1/1/11, incl. originator retaining a net economic interest of not less than 5%
21	Art. 17	Investment in securitisation positions	Qualitative requirements to be met by AIFM which invest in these securities or other financial instruments
22	Art. 18(2)	General principles (organizational requirements)	Procedures and arrangements regarding the proper management of AIF
23	Art. 19(11)	Valuation	Criteria concerning procedures for the proper valuation of assets and calculation of NAV per share or unit
24	Art. 19(11)	Valuation	Professional guarantees external valuer must be able to furnish
25	Art. 19(11)	Valuation	Frequency of valuation carried out by open-ended funds
26	Art. 20(5)	Delegation	Conditions for fulfilling the requirements regarding delegation
27	Art. 20(5)	Delegation	Conditions under which the manager has delegated its functions to the extent that it becomes a letter-box entity
28	*Art. 21*	*Depositary*	*not part of this package of level 2 measures*
29	Art. 21(15)	Depositary	Particulars to be included in the standard agreement between depositary and AIFM
30	Art. 21 (5)	Depositary	General criteria for assessing whether the prudential regulation and supervision of 3rd countries are to the same

	Article	Area	Description
			effect as EU law and effectively enforced
31	Art. 21(17)	Depositary	Conditions for performing the depositary functions
32	Art. 21(15)	Depositary	Due diligence duties of depositaries
33	Art. 21(15)	Depositary	Segregation obligation
34	Art. 21(15)	Depositary	Conditions and circumstances under which financial instruments held in custody shall be considered as lost
35	Art. 21(15)	Depositary	What is to be understood by external events beyond reasonable control, the consequences of which would have been unavoidable despite all efforts to the contrary
36	Art. 21(15)	Depositary	Conditions and circumstances under which there is an objective reason to contract a discharge
37	Art. 22(4)	Annual report	Content and format of the annual report; adapted to the type of AIF to which they apply.
38	Art. 23(6)	Disclosure to investors	Disclosure obligations of AIFM; adapted to the type of AIFM to which they apply.
39	Art. 24(6)	Reporting obligations to CA	When leverage is considered to be employed on a substantial basis
40	Art. 24(6)	Reporting obligations to CA	Obligations to report and provide information.
41	Art. 25(9)	Use of information by CA, supervisory cooperation and limits to leverage	Principles specifying the circumstances in which competent authorities exercise the right to set limits on leverage
42	Art. 34(2)	Conditions for EU AIFM which manage non-EU AIF which are not marketed in MS	Cooperation arrangements to design a common framework to facilitate the establishment of those arrangements with 3rd countries
43	Art. 35(11)	Conditions for marketing in the EU with passport of a non-EU AIF managed by an EU AIFM	Cooperation arrangements to design a common framework to facilitate the establishment of those arrangements with 3rd countries
44	Art. 36(3)	Conditions for marketing in MS without passport of non-EU AIF managed by an EU AIFM	Cooperation arrangements to design a common framework to facilitate the establishment of those arrangements with 3rd countries
45	Art. 37(13)	Authorisation of non-EU AIFM intending to manage EU AIF and/or market AIF managed by it in the EU	Procedure to be followed by the possible MS of reference when determining the MS of reference
46	Art. 37(14)	Authorisation of non-EU AIFM intending to manage EU AIF and/or market AIF managed by it in the EU	Cooperation arrangements to design a common framework to facilitate the establishment of those arrangements with 3rd countries
47	Art. 39(11)	Conditions for marketing in the EU with passport of non-EU AIF managed by a non-EU AIFM	Cooperation arrangements to design a common framework to facilitate the establishment of those arrangements with 3rd countries
48	Art. 40(3)	Conditions for marketing in MS without passport of AIF managed by a non-EU AIFM	Cooperation arrangements to design a common framework to facilitate the establishment of those arrangements with 3rd countries
49	Art. 53(3)	Exchange of information relating to the potential systemic consequences of AIFM activity	Content of the information to be exchanged
50	Art. 53(4)	Exchange of information relating to the potential systemic consequences of AIFM activity	Modalities and frequency of the information to be exchanged

Annex 5: Exposure of an AIF

Exposure of a fund or any investor describes the extent to which it is exposed to market risk, credit risk or other types of risk. A fund 1 that has collected 100m€ from investors and invests these in shares, has an exposure of 100m€ as it can lose these 100m€ if the firm that issued the shares goes bankrupt and there is no money left in the insolvency to repay shareholders. Another fund 2 has also collected 100m€ but in addition borrows money from a bank, for sake of simplicity also 100m€, and invests this money as well in the same share. Now the exposure of the fund 2 would be 200m€, although it has only 100m€ of investor money. It would be 100% leveraged. The expectation of the fund manager is that the fund would gain more from the investment in the share than the interest it has to pay to the bank. Let us assume that the share price goes up 10% within a year and the interest rate for the loan is 2%, Both funds sell their shares and fund 2 repays the loan plus interests. Fund 1 would have earned 10m€ and the investors would get 1.1€ back for each Euro invested, a return of 10%. Fund 2, however, has gained 20m€ from its investment and has to pay the bank 2m€. Its gain on the investors' money is therefore 18m€, or a rate of return of 18%. This means that the rate of return of the fund (18%) is higher than the rate of return from the asset it had invested in (10%). Unfortunately, this leverage effect works both ways; if the share price goes down 10% instead of up, investors in fund 1 would lose 10%, while investors in fund 2 would lose 22% (the value of the investment goes down from 200 to 180m€ and the fund has to pay 100m€ back to the bank plus 2m€ interest, leaving 78m€ for the investors). – The value of a leveraged fund fluctuates more than the value of a non-leveraged fund invested in the same assets.

Annex 6: Problems to be addressed, objectives to be achieved by implementing or delegated acts

	Problems addressed (Level 1)					
	Registration and authorisation of AIFM	Macro-prudential (systemic) risks, use of leverage	Micro-prudential risks	Investor protection	Market efficiency and integrity	
	Operational objectives (Level 1)					
	All AIFM satisfy specific requirements	Transparency of AIFM activity, incl leverage, effective monitoring of systemic risks Relevant macro-prudential data timely shared at EU level	Risk management controls (market, liquidity, counterparty and operational risks)	Reduce weakness in investor disclosures; Proper management of conflicts of interest; Appropriate controls and processes in key risk areas	Remove barriers to efficient cross-border marketing of AIF to professional investors without compromising effectiveness of regulation and supervision	Focus on AIFM of systemic relevance, impose requirements calibrated to specific activities and behaviours
	Operational objectives (Level 2)					
No	Calculation of thresholds not to allow AIFM to circumvent regulation, nor to empty the level 1 exemption	Supervisors to be provided with relevant information in a format that allows it to be disseminated and aggregated in a timely manner	Level 1 rules to ensure effective risk reduction while balancing harmonisation and flexibility	Investors to be provided with all relevant information in a timely manner	Investors to be provided with comparable information about AIF marketed in the EU balancing the need for harmonisation and flexibility	Reporting requirements and restrictions to be applied in a proportionate way balancing the need for harmonisation and flexibility
1	**x**			**x**	**x**	
2	**x**	**x**	**x**	**x**		**x**
3	**x**	**x**				**x**
4	**x**					
5	**x**	**x**		**x**	**x**	**x**
6	**x**	**x**		**x**	**x**	**x**
7			**x**	**x**		
8			**x**	**x**	**x**	
9			**x**	**x**	**x**	
10	**x**		**x**	**x**	**x**	
11			**x**			
12			**x**	**x**		
13	**x**		**x**	**x**		
14			**x**	**x**		
15			**x**	**x**		
16			**x**	**x**		
17			**x**	**x**		
18	**x**		**x**	**x**		
19			**x**	**x**		
20		**x**				

	Problems addressed (Level 1)					
	Registration and authorisation of AIFM	Macro-prudential (systemic) risks, use of leverage	Micro-prudential risks	Investor protection	Market efficiency and integrity	
	Operational objectives (Level 1)					
	All AIFM satisfy specific requirements	Transparency of AIFM activity, incl leverage, effective monitoring of systemic risks Relevant macro-prudential data timely shared at EU level	Risk management controls (market, liquidity, counterparty and operational risks)	Reduce weakness in investor disclosures; Proper management of conflicts of interest; Appropriate controls and processes in key risk areas	Remove barriers to efficient cross-border marketing of AIF to professional investors without compromising effectiveness of regulation and supervision	Focus on AIFM of systemic relevance, impose requirements calibrated to specific activities and behaviours
	Operational objectives (Level 2)					
No	Calculation of thresholds not to allow AIFM to circumvent regulation, nor to empty the level 1 exemption	Supervisors to be provided with relevant information in a format that allows it to be disseminated and aggregated in a timely manner	Level 1 rules to ensure effective risk reduction while balancing harmonisation and flexibility	Investors to be provided with all relevant information in a timely manner	Investors to be provided with comparable information about AIF marketed in the EU balancing the need for harmonisation and flexibility	Reporting requirements and restrictions to be applied in a proportionate way balancing the need for harmonisation and flexibility
21		**x**				
22			**x**	**x**		
23			**x**	**x**		
24			**x**	**x**		
25			**x**	**x**		
26	**x**					
27	**x**		**x**	**x**		
28						
29			**x**	**x**		
30			**x**	**x**		
31			**x**	**x**		
32			**x**	**x**		
33			**x**	**x**		
34			**x**	**x**		
35			**x**	**x**		
36		**x**	**x**	**x**		
37				**x**	**x**	
38				**x**	**x**	
39		**x**		**x**	**x**	**x**
40		**x**		**x**	**x**	**x**
41		**x**				**x**

No	Problems addressed (Level 1)					
	Registration and authorisation of AIFM	Macro-prudential (systemic) risks, use of leverage	Micro-prudential risks	Investor protection	Market efficiency and integrity	
	Operational objectives (Level 1)					
	All AIFM satisfy specific requirements	Transparency of AIFM activity, incl leverage, effective monitoring of systemic risks Relevant macro-prudential data timely shared at EU level	Risk management controls (market, liquidity, counterparty and operational risks)	Reduce weakness in investor disclosures; Proper management of conflicts of interest; Appropriate controls and processes in key risk areas	Remove barriers to efficient cross-border marketing of AIF to professional investors without compromising effectiveness of regulation and supervision	Focus on AIFM of systemic relevance, impose requirements calibrated to specific activities and behaviours
	Operational objectives (Level 2)					
	Calculation of thresholds not to allow AIFM to circumvent regulation, nor to empty the level 1 exemption	Supervisors to be provided with relevant information in a format that allows it to be disseminated and aggregated in a timely manner	Level 1 rules to ensure effective risk reduction while balancing harmonisation and flexibility	Investors to be provided with all relevant information in a timely manner	Investors to be provided with comparable information about AIF marketed in the EU balancing the need for harmonisation and flexibility	Reporting requirements and restrictions to be applied in a proportionate way balancing the need for harmonisation and flexibility
42		x		x	x	
43		x		x	x	
44		x		x	x	x
45	x	x		x	x	
46		x		x	x	
47		x		x	x	
48		x		x	x	x
49		x				x
50		x				x

Annex 7: Assessment of need for detailed IA for individual level 2 measures

The issues that are discussed in detail in this IA report are shaded in gray.

- **Issue 1 – Article 3 Exemptions**

1 a) – Opt-in procedure for AIFM below the threshold (Article 3, paragraph 4; implementing powers, Article 3, paragraph 5)

AIFM below certain thresholds do not benefit from any of the rights granted under this Directive, unless the AIFM chooses to opt-in under this Directive in which case the entire Directive, subject to the exceptions set forth therein would be applicable to those AIFM.

Implementing measures should specify the procedures for AIFM which choose to opt-in.

Assessment of IA need

This implementing measure had been introduced because co-legislators were concerned that the administrative burden might not be proportionate for smaller AIFMs if they were forced to comply with the same requirements as larger AIFMs.

There were therefore two options to be considered:

- Option 1: Lighter requirements for AIFM who opt-in voluntarily.
- Option 2: Imposing the same requirements on AIFM who opt-in voluntarily as for AIFM above the threshold.

However, already preliminary considerations of these options reveal that option 2 was the only viable one: A lighter regime for smaller AIFM would only bring a minor reduction in administrative burden at the time of authorisation as most of the requirements were regarded as indispensible. But even these savings would in most cases only be of a temporary nature as most of these AIFM would most likely be already close to the threshold and would then have to comply with the remaining requirements at the time they grow above the threshold in order to ensure full compliance with the Directive and a level playing field with other AIFM. In addition, they would have to monitor/calculate their total assets under management permanently in order to ensure that they submit the remaining documents once they exceed the threshold. The unlevel playing field between AIFM below and above the threshold would be another disadvantage of option 1.

1 b) – Thresholds – calculation, oscillation, obligations below thresholds (Article 3, paragraph 2 and 3; implementing powers, Article 3, paragraph 6)

The application of the Directive is limited to:

(a) AIFM which either directly or indirectly through a company with which the AIFM is linked by common management or control, or by a substantive direct or indirect holding, manage portfolios of AIF whose assets under management, including any assets acquired through use of leverage, in total do not exceed a threshold of EUR 100 million; or

(b) AIFM which either directly or indirectly through a company with which the AIFM is linked by common management or control, or by a substantive direct or indirect holding, manage portfolios of AIF whose assets under management, in total do not exceed a threshold of EUR 500 million when the portfolio of AIF consists of AIF that are not leveraged and have no redemption rights exercisable during a period of 5 years following the date of initial investment in each AIF.

Among other things, AIFM below the threshold are subject to a registration with the competent authorities of its home Member State; and have to notify the competent authorities of its home Member State in the event that they no longer comply with the conditions for exemption.

Delegated acts should specify (a) how to calculate the thresholds and to treat AIFM whose assets under management, including any assets acquired through use of leverage, in one and the same calendar year occasionally exceed and/or fall below the relevant threshold; (b) the obligations to register for the entities below the threshold and to provide information in order to effectively monitor systemic risk; and (c) the obligations to notify competent authorities if they do no longer comply with the requirements for exemption.

- **Calculation of the thresholds**

Assessment of IA need

Dealt with in detail in the body of the IA report

- **Treatment of AIFM in one and the same calendar year occasionally exceed and/or fall below the relevant threshold:**

Assessment of IA need

Calculations by […] showed that there were only a very limit number of AIFM with total assets under management (AuM) close to the threshold in France. For those slightly above the threshold it could be reasonably assumed that they would keep their authorisation if they should fall below the threshold but assumed that they would be above again soon. Designing specific requirements for AIFM with AuM slightly below the threshold, but exceeding it occasionally, seemed disproportionate as they would have the seek authorisation anyway if they were above the threshold for consecutive annual calculations of the AuM. Given that these AIFM are nevertheless relatively small and have already to comply with the minimum requirements of this article, and that the authorisation process takes a couple of months, any more detailed requirements seemed excessive as the benefit would not outweigh the costs for AIFM and competent authorities.

The reporting frequency for AIFM is discussed as issue 7 in the IA report. There it is assessed that more frequent than annual reporting for AIFM below the threshold would be too burdensome and inappropriate regarding the added value it would bring. As a consequence of this any temporary exceeding of the threshold by a below-threshold AIFM would not be recognised. The other case of an AIFM above the threshold that falls below it during the year, is not relevant as there is not even a specific regime for AIFM falling permanently below the threshold.

- **Obligations to register and to provide information in order to effectively monitor systemic risk and obligations to notify competent authorities:**

Assessment of IA need

In view of the limited margin for options on these obligations from level 1, and the resulting limited impact on potential administrative burden for AIFM on the one hand and potential issues of systemic risk monitoring on the other, a detailed IA would not be appropriate. These issues did not feature prominent in the discussions at ESMA nor among stakeholders.

o **Issue 2 - Article 4 Definition of leverage**

I. Article 4, paragraph 1, implementing powers, Article 4, paragraph 3:

The AIFMD defines 'Leverage' as "any method by which the AIFM increases the exposure of an AIF it manages whether through borrowing of cash or securities, or leverage embedded in derivative positions or by any other means".

Delegated acts should specify (a) the methods of leverage, including any financial and/or legal structures involving third parties controlled by the relevant AIF; and (b) how leverage shall be calculated.

Assessment of IA need

- o Specifying the methods of leverage, including any financial and/or legal structures involving third parties, as defined in point (v) of paragraph 1 [leverage]:

Because of the wording of AIFMD Article 4(1), any specification could only be of an indicative nature, i.e a non-exhaustive list of methods, the inclusion or not of a specific method would not have major impacts. Therefore, a detailed IA does not seem to be needed.

o Specifying how leverage shall be calculated:

Assessment of IA need

Dealt with in detail in the body of the IA report

o **Issue 3 – Article 9 Initial capital and own funds**

Article 9, paragraph 7; implementing powers, Article 9, paragraph 9:

To cover potential professional liability risks resulting from activities the AIFM may carry out both internally managed AIF and externally appointed AIFM should either have additional own funds which are appropriate to cover potential liability risks arising from professional negligence; or hold an appropriate professional indemnity insurance against liability arising from professional negligence which is appropriate to the risks covered.

Delegated acts should specify (a) the risks the additional own funds or the professional indemnity insurance must cover; (b) the conditions for determining the appropriateness of additional own funds or the coverage of the professional indemnity insurance; (c) the manner of determining ongoing adjustments of the additional own funds or of the coverage of the professional indemnity insurance.

Assessment of IA need

- o Risks the additional own funds or the professional indemnity insurance must cover:

The approach suggested by ESMA is based on Annex X of Directive 2006/48/EC of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast)[41], classifying potential loss events that may lead to liabilities of the AIFM and thus should be considered as liability risk. This classification is not exhaustive and has not been fundamentally challenged in consultations run by ESMA, no relevant alternatives to this approach have been presented. Therefore, this issue has not been impact assessed further.

[41] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:177:0001:0001:EN:PDF

- Conditions for determining the appropriateness of additional own funds or the coverage of the professional indemnity insurance:

Assessment of IA need

Dealt with in detail in the body of the IA report

- Manner of determining ongoing adjustments of the additional own funds or of the coverage of the professional indemnity insurance:

There was consensus that the rules regarding ongoing adjustments should not create additional costs but take place as part of the annual reporting cycle. More frequent adjustments would trigger valuation costs, monitoring costs, costs of renegotiation etc. without major benefits.

'Ongoing adjustments' would in any case take place at least annually. As PII would not be adjusted more than once per year, in order to keep a level playing field with AIF using additional own funds the same frequency should apply.

- **Issue 4 - Article 12 General principles**

Article 12, paragraph 1; implementing powers paragraph 3:

AIFM have to comply with the following on an ongoing basis.

(a) act honestly, with due skill, care and diligence and fairly in conducting its activities;

(b) act in the best interests of the AIF or the investors of the AIF it manages and the integrity of the market;

(c) have and employ effectively the resources and procedures that are necessary for the proper performance of its business activities;

(d) take all reasonable steps to avoid conflicts of interests and, when they cannot be avoided, to identify, prevent, manage and monitor, and where applicable, disclose, those conflicts of interest in order to prevent them from adversely affecting the interests of the AIF and its investors and to ensure that the AIF it manages are fairly treated;

(e) comply with all regulatory requirements applicable to the conduct of its business activities so as to promote the best interests of the AIF or the investors of the AIF it manages and the integrity of the market;

(f) treat all AIF investors fairly.

No investor in an AIF may obtain a preferential treatment, unless this is disclosed in the relevant AIF's rules or instruments of incorporation.

Delegated acts should specify the criteria to be used by the relevant competent authorities to assess whether AIFM comply with the above obligations.

Assessment of IA need

The issue is very similar if not identical to other EU law (UCITS/MiFID). As there were no reasons for major deviations from these rules, a detailed IA did not seem to be proportionate.

- **Issue 5 - Article 14 Conflicts of interest**

Article 14, paragraph 1; implementing powers, Article 14, paragraph 4:

AIFM have to take all reasonable steps to identify conflicts of interest that arise in the course of managing one or more AIF between:

(a) the AIFM, including their managers, employees or any person directly or indirectly linked to the AIFM by control, and the AIF managed by the AIFM or the investors of this AIF; or

(b) one AIF or the investors of this AIF and another AIF or the investors of this AIF, or

(c) the AIF or the investors of the AIF and another client of the AIFM; or

(d) the AIF or the investors of the AIF and a UCITS managed by the AIFM or the investors of such UCITS; or

(e) two of the AIFM's clients.

AIFM have to maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to identify, prevent, manage and monitor conflicts of interest in order to prevent them from adversely affecting the interests of the AIF and its investors.

They have to segregate within their own operating environment, tasks and responsibilities which may be regarded as incompatible with each other or which may potentially generate systematic conflicts of interest. And finally they are to assess whether its operating conditions may involve any other material conflicts of interest and disclose them to the AIF investors.

Delegated acts should specify (a) the types of conflicts of interests referred to in the above; and (b) the reasonable steps AIFM are expected to take in terms of structures and organizational and administrative procedures in order to identify, prevent, manage, monitor and disclose conflicts of interest.

Assessment of IA need

- Specifying the types of conflicts of interests:

The issue and therefore the advice are very similar if not identical to UCITS/MiFID. The present IA will therefore primarily refer to the respective UCITS level 2 IA for these measures and concentrate on potential need for differentiation between UCITS and AIFM.

- Specifying the reasonable steps AIFM are expected to take in terms of internal and organizational procedures in order to identify, prevent, manage, monitor and disclose conflicts of interest:

The issue and therefore the advice are very similar if not identical to UCITS/MiFID rules. The present IA will therefore primarily refer to the respective UCITS level 2 IA for these measures and concentrate on potential need for differentiation between UCITS and AIFM.

- **Issue 6 – Article 15 Risk management**

Article 15, paragraph 1-3; implementing powers, Article 15, paragraph 5:

The AIFM shall functionally and hierarchically separate the functions of risk management from the operating units, including the portfolio management.

This functional and hierarchical separation has to be reviewed by the competent authorities of the home Member State of the AIFM in line with the principle of proportionality, in the understanding that the AIFM must in any event be able to demonstrate that 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 this Article and is consistently effective.

The AIFM has to implement adequate risk management systems 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. It has to review the risk management systems with appropriate frequency, no less than once a year, and adapt it, whenever necessary.

The AIFM has at least to:

(a) implement an appropriate, documented and regularly updated due diligence process when investing on behalf of the AIF, according to the investment strategy, the objectives and risk profile of the AIF;

(b) ensure that the risks associated to each investment position of the AIF and their overall effect on the AIF's portfolio can be properly identified, measured managed and monitored on an ongoing basis including through the use of appropriate stress testing procedures;

(c) ensure that the risk profile of the AIF shall correspond to the size, portfolio structure and investment strategies and objectives of the AIF as laid down in the AIF rules or instruments of incorporation, prospectus and offering documents.

Delegated acts should specify:

(a) the risk management systems to be employed by AIFM as a function of the risks which the AIFM incurs on behalf of the AIF that it manages;

(b) the appropriate frequency of review of the risk management system;

(c) how the risk management function shall be functionally and hierarchically separated from the operating units, including the portfolio management function;

(d) specific safeguards against conflicts of interest referred to in the above;

(e) the requirements regarding due diligence, risk management and the alignment of the risk profile.

Assessment of IA need

As AIFM may also be subject to risk management requirements imposed by MiFID and/or UCITS, coherence with these requirements is key factor in the design of the implementing measures. The existence of a well-developed and proven regulatory framework for UCITS limits de facto the scope of the considerations for the development of implementing measures to the question whether there are valid reasons to deviate from those rules. As the types of AIFM differ even more than the types of UCITS, such implementing measures have to take a relatively general, principles-based approach which makes it difficult to develop clearly defined distinct options and to impact assess differences between them.

o **Issue 7 - Article 16 Liquidity management**

Article 16, paragraph 1 and 2; implementing powers, Article 16, paragraph 3:

The AIFM shall for each AIF it manages, that is not an unleveraged closed-ended AIF, employ an appropriate liquidity management system and adopt procedures which enable it to monitor the liquidity risk of the AIF and to ensure that the liquidity profile of the investments of the AIF complies with its underlying obligations.

The AIFM has to regularly conduct stress tests, under normal and exceptional liquidity conditions, which enable it to assess the liquidity risk of the AIF and monitor the liquidity risk of the AIF accordingly. It has to ensure that for each AIF it manages the investment strategy, the liquidity profile and the redemption policy are consistent.

Delegated acts should specify the liquidity management systems and procedures, and the alignment of the investment strategy, liquidity profile and redemption policy.

Assessment of IA need

The purpose of the liquidity management provisions is to ensure that all AIFM implement appropriate liquidity management systems and procedures, so as to ensure that the liquidity profile of the fund's investments is consistent with the underlying obligations towards investors. Similar to the implementing measures on risk management the similarities with UCITS provide a strong case for basing AIFMD implementing measures on those for UCITS. The scope of relevant options is therefore substantially restricted and does not provide a case for a detailed IA.

- **Issue 8 - Article 17 and Article 61 (new Article 50a in UCITS) Investment in securitisation positions**

In order to ensure cross-sectorial consistency and to remove misalignment between the interest of firms that repackage loans into tradable securities and originators within the meaning of Article 4(41) of Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions (recast), and AIFM that invest in these securities or other financial instruments on behalf of one or more AIF delegated acts should lay down the requirements in the following areas:

(a) the requirements that need to be met by the originator, the sponsor or the original lender, in order for an AIFM to be allowed to invest in securities or other financial instruments of this type issued after 1 January 2011 on behalf of one or more AIF, including requirements that ensure that the originator, the sponsor or the original lender, retains a net economic interest of not less than 5 per cent.

(b) qualitative requirements that must be met by AIFM which invest in these securities or other financial instruments on behalf of one or more AIF.

Assessment of IA need

The provision on investment in securitisation positions is intended to address the potential misalignment between the interests of firms that repackage loans into tradable securities and originators, on the one hand, and the AIFM that invest in those securities, on the other.

These provisions are to be applied on a horizontal basis across all regulated financial services sectors. In developing implementing measures, full account has to be taken of the need for cross-sectorial consistency in the content of these provisions. The implementing measures have therefore to be consistent with the relevant provisions of the Capital Requirements Directive.

Moreover, as Articles 17 and 61 comprise the same delegation to the Commission the implementing measures should be applicable both to the AIFM and the UCITS Directive.

These cross-sectorial consistency requirements do not leave much room for different options for the implementing measures under AIFMD (and UCITS). Furthermore, the CRD rules have already been impact-assessed (http://ec.europa.eu/internal_market/bank/docs/regcapital/com2009/_impact_assesment_en.pdf). Additional impact assessment work for the AIFMD would lead to duplication of work while being unlikely to reveal new information.

o **Issue 9 –Organisational requirements, Article 18 General principles**

Article 18, paragraph 1; implementing powers, Article 18, paragraph 2:

At all times, AIFM have to use adequate and appropriate human and technical resources that are necessary for the proper management of AIF.

In particular, the AIFM has to have sound administrative and accounting procedures, control and safeguard arrangements for electronic data processing and adequate internal control mechanisms including, in particular, rules for personal transactions by its employees or for the holding or management of investments in order to invest on its own account and ensuring, at least, that each transaction involving the AIF may be reconstructed according to its origin, the parties to it, its nature, and the time and place at which it was effected and that the assets of the AIF managed by the AIFM are invested according to the fund rules or the instruments of incorporation and the legal provisions in force.

Delegated acts should specify these procedures and arrangements.

Assessment of IA need

The provisions on general principles of organisation are identical to those of the UCITS Directive. An appropriate level of consistency with the corresponding provisions UCITS and other directives is important, while due consideration has to be given to the differences between AIFM and the entities regulated by those directives. As the implementing measures have been well-established and proven under UCITS and in relatively general terms, there are no convincing reasons to deviate from those. Accordingly, it can also be relied on the IA work done for the UCITS implementing measures [http://ec.europa.eu/internal_market/investment/docs/legal_texts/framework/100521-impact_assessment_en.pdf].

o **Issue 10 - Article 19 Valuation**

Article 19, paragraph 1-3, 5; implementing powers, Article 19, paragraph 11:

The AIFM has to ensure that, for each AIF that it manages, appropriate and consistent procedures are established so that a proper and independent valuation of the assets of the AIF can be performed in accordance with this Article and the applicable national and AIF rules.

The rules applicable to the valuation of assets and the calculation of the net asset value per share or unit of the AIF shall be laid down in the law of the country where the AIF has its registered office and/or in the AIF rules or instruments of incorporation.

The AIFM has also to ensure that the net asset value per share or unit of AIF is calculated and disclosed to the investors in accordance with this Article, the applicable national law and the AIF rules or instruments of incorporation.

The valuation procedures used shall ensure that the assets are valued and the net asset value per share or unit calculated at least once a year.

If the AIF is of the open-ended type, such valuations and calculations shall also be carried out at a frequency which both is appropriate to the assets held by the fund and its issuance and redemption frequency.

When an external valuer is performing the valuation function, the AIFM shall be able to demonstrate that the external valuer can furnish sufficient professional guarantees to be able to effectively perform the relevant valuation function.

Delegated acts should specify:

(a) the criteria concerning the procedures for the proper valuation of the assets and the calculation of the net asset value per share or unit;

(b) the professional guarantees the external valuer must be able to furnish to effectively perform the valuation function;

(c) the frequency of valuation carried out by open-ended funds which is both appropriate to the assets held by the fund and its issuance and redemption policy.

Assessment of IA need

The fundamental principle of the valuation provisions of the AIFM Directive is that processes should be in place to ensure the proper and independent valuation of the assets of the AIF. In developing level 2 in this area, full account has to be taken of the diverse range of assets in which an AIF, or an AIFM on its behalf, may invest. To reflect this diversity, only relatively general criteria could be applied across the board. The alternative would be to develop more detailed rules specific for the various types of asset. This, however, would require very fine differentiation and thereby eliminate on the one hand the flexibility needed to comply with national valuation standards and on the other hand risk nevertheless leaving some gaps for certain types of asset, in particular in the future if new types of asset should emerge.

In view of this considerable risk and the limited additional benefit of very detailed rules, the advantages of the option of general principles seemed so obvious that no detailed IA is required. This is further supported by the fact that for some of the issues to be addressed like the appropriate valuation frequency recourse could be made to UCITS rules and that, as for other issues, the main thrust of both benefits and compliance costs is already triggered by the level 1 Directive.

- **Issue 11 – Article 20 Delegation of AIFM functions**

Article 20, paragraph 1-3; implementing powers, Article 20, paragraph 5:

AIFM which intend to delegate to third parties the task of carrying out on their behalf one or more of their functions shall notify the competent authorities of their home Member State before the delegation arrangements become effective.

The following conditions have to be complied with:

(a) the AIFM must be able to justify its entire delegation structure with objective reasons;

(b) the delegate must dispose of sufficient resources to perform the respective tasks and the persons who effectively conduct the business must be of sufficiently good repute and sufficiently experienced;

(c) where the delegation concerns the portfolio management or the risk management, the mandate must be given only to undertakings which are authorised or registered for the purpose of asset management and subject to supervision. Where this condition cannot be satisfied, delegation may only be given on the condition of prior approval by the competent authorities of the home Member State of the AIFM;

(d) where the delegation concerns the portfolio management or the risk management and is given to a third-country undertaking, in addition to the requirements in point (c), co-operation between the competent authorities of the home Member State of the AIFM and the supervisory authority of the undertaking shall be ensured;

(e) the delegation shall not prevent the effectiveness of supervision of the AIFM, and in particular, it must not prevent the AIFM from acting, or the AIF from being managed, in the best interests of its investors;

(f) the AIFM must be able to demonstrate that the delegate is qualified and capable of undertaking the functions in question, that it was selected with all due care and that the AIFM is in a position to monitor effectively at any time the delegated activity, to give at any time further instructions to the delegate and to withdraw the delegation with immediate effect when this is in the interest of investors.

No delegation of portfolio management or risk management shall be given to

(i) the depositary or to a delegate of the depositary, or

(ii) any other entity whose interests may conflict with those of the AIFM or the investors of the AIF, unless such entity has functionally and hierarchically separated the performance of its portfolio management or risk management tasks from its other potentially conflicting tasks, and the potential conflicts of interest are properly identified, managed, monitored and disclosed to the investors of the AIF.

The AIFM shall review the services provided by each delegate on an ongoing basis.

In no case shall the AIFM's liability towards the AIF and its investors be affected by the fact that the AIFM has delegated functions to a third party, or by any further sub-delegation, nor shall the AIFM delegate its functions to the extent that, in essence, it can no longer be considered to be the manager of the AIF and to the extent that it becomes a letter-box entity.

The third party may sub-delegate any of the functions delegated to it as long as the following conditions are fulfilled:

(a) the AIFM consented prior to the sub-delegation;

(b) the AIFM notified the competent authorities of its home Member State before the sub-delegation arrangements become effective;

(c) the conditions set forth in paragraph 1 points (a) to (f), in the understanding that all references to the 'delegate' shall be read as references to the 'sub-delegate'.

No sub-delegation of portfolio management or risk management shall be given to the depositary or to a delegate of the depositary, or any other undertaking whose interests may conflict with those of the AIFM or the investors of the AIF, unless such entity has functionally and hierarchically separated the performance of its portfolio management or risk management tasks from its other potentially conflicting tasks, and the potential conflicts of interest are properly identified, managed, monitored and disclosed to the investors of the AIF.

The relevant delegate shall review the services provided by each sub-delegate on an on-going basis.

Delegated acts should specify the conditions for fulfilling the above requirements and the conditions under which the manager has delegated its functions to the extent that it becomes a letter-box entity.

Assessment of IA need

The purpose of the Level 2 provisions is to further specify the conditions for delegation and sub-delegation; and to define the conditions under which an AIFM would be considered to have delegated functions to an extent that it becomes a letter-box entity and to an extent to which it can no longer be considered to be the manager of the AIF.

Several Articles at level 1 are relevant in identifying the extent to which an AIFM may delegate without the risk of being considered either a 'letter box entity' or as no longer being the manager of an AIF. Articles 6, 5 and 4 AIFMD contain a clear set of criteria specifying the main features and activities of an AIFM, which have to be taken into account when assessing instances in which an AIFM risks becoming a 'letter box entity' and in which the AIFM can no longer be considered as the manager of an AIF:

1. According to Article 6(5) AIFMD an AIFM shall only be authorised to provide portfolio management services (point 1(a) of Annex I) if the AIFM also provides risk management services (point 1(b) of Annex I).

2. According to Article 5(1) AIFMD each AIF managed within the scope of the AIFMD shall have a single AIFM who shall be responsible for managing the AIF (cf. Article 5(1)(a)AIFMD).

3. According to Article 4(w) 'managing' an AIF means performing at least the investment management functions referred to in point 1(a) or (b) of Annex I for one or more AIFs.

Therefore, read together, the provisions provide a detailed enumeration of the steps to be undertaken for assessing whether delegation occurs within the limits set out by the AIFMD:

- They require that the AIFM has to perform itself at least the portfolio or the risk management function, whilst it has to be authorised for providing them both.

- As an AIFM can be authorised only if it provides the two functions, it needs to have the necessary resources and powers. In addition, the requirement to perform at least one of these functions supposes that the AIFM effectively exercises some investment management activities itself.

Therefore, in strict adherence to level 1, an AIFM that does provide both portfolio and risk management functions while not performing at least one of these functions itself is to be considered a letter box entity and an entity that cannot be considered to be the manager of the AIF.

It is against this background that the Commission has to exercise its empowerment contained in Article 20(7)(b). The empowerment for additional clarification at level 2 is strictly circumscribed by the parameters that are contained in the above mentioned provisions at level 1.

In light of this tight mandate, the Commission's empowerment contained in Article 20(7)(b) is narrowly confined by the policy choices taken in the above mentioned level 1 provisions. There is no discretion to deviate from the precise parameters set at level 1. In these circumstances, a detailed IA examining several options on how to implement the empowerment was not deemed appropriate or suitable.

DEPOSITARY (ARTICLE 21)

- **Issue 12 – General criteria for assessing equivalence of the effective prudential regulation and supervision of third countries**

Article 21, paragraph 5:

For non-EU AIF, the depositary shall be established in the third country where the AIF is established, or in the home Member State of the AIFM managing the AIF, or, as the case may be, in the Member State of reference of the AIFM managing the AIF.

The appointment of a depositary established in a third country shall at all times be subject to the condition that in the third country where the depositary is established depositaries are subject to effective prudential regulation (including minimum capital requirements) and supervision which are to the same effect as the provisions laid down in European Union law and which are effectively enforced;

Delegated acts should specify the criteria for assessing that the prudential regulation and supervision of third countries are to the same effect as the provisions laid down in European law and are effectively enforced.

Assessment of IA need

This delegated act only defines the criteria to be used in the actual assessment of whether prudential regulation and supervision of a third country are to the same effect. In order to ensure that regulation and supervision in a third country are to the same effect, the criteria to be established have to mirror the requirements of Article 21 AIFMD very closely. Therefore, the options in an IA could not differ very much. Accordingly, the differences in the incremental impacts of options would also be small. This, combined with the fact that it would only be an IA on criteria, not on their application, suggests that no detailed IA of this implementing measure had to be prepared.

- **Issue 13 – Contract evidencing appointment of the depositary**

Article 21, paragraph 2; implementing powers, Article 21, paragraph 15:

The appointment of the depositary has to be evidenced by a contract in writing. The contract should, among others, regulate the flow of information deemed necessary to allow the depositary to perform its functions for the AIF for which it has been appointed as depositary, as set out in this Directive and in other relevant laws, regulations or administrative provisions.

Delegated acts should specify the particulars that need to be included in the standard agreement.

Assessment of IA need

As the appointment of a depositary has to be done in writing anyway and as such contracts are common practice for most part of the fund industry, no relevant impacts are to be expected from such a standard agreement and therefore no IA work has been conducted.

- **Issue 14 – Due diligence**

Article 21, paragraph 10; implementing powers, Article 21, paragraph 15:

The depositary may only delegate to third parties provided that, among others, the depositary has exercised all due skill, care and diligence in the selection and the appointment of any third party to whom it wants to delegate parts of its tasks, and shall keep exercising all due skill, care and diligence in the periodic review and ongoing monitoring of any third party to whom it has delegated parts of its tasks and of the arrangements of the third party in respect of the matters delegated to it.

Delegated acts should specify the due diligence duties of depositaries

Assessment of IA need

As the overall content of the due diligence duties proposed by ESMA reflect common business practice and have not been challenged, the options for an IA would only be whether these duties should be prescribed in a comprehensive template or in a more open form. However, as the former would formally provide more legal certainty, it would have a number of significant short-comings or risks. Firstly, the more detailed rules are the less flexible and adjustable to specific cases they become. Secondly, definite lists of provisions risk luring depositaries into box-ticking exercises instead of proper ‘active’ due diligence. Thirdly, the overall liability of the depositary, including, in some instances, for acts of the delegate, should avoid that depositaries take due diligence lightly and therefore weakens the case for detailed rules. Because of this limited number of options where one has overwhelming advantages, no further in-depth IA work seemed necessary.

- **Issue 15 – The segregation obligation**

Article 21, paragraph 10; implementing powers, Article 21, paragraph 15:

The depositary may only delegate to third parties provided that, among others, the depositary has ensured that the third party segregates the assets of the depositary's clients from its own assets and from the assets of the depositary in such a way that they can at any time be clearly identified as belonging to clients of a given depositary and that it complies with this requirement on an ongoing basis. The third party may, in turn, sub-delegate those functions subject to the same requirements.

Delegated acts should specify this segregation obligation.

Assessment of IA need

Similar rules exist already in MiFID. As there is no obvious reason to deviate substantially from those, there is also no need for a detailed IA. As regards the segregation of assets in case of further delegation, Level 1 imposes the same requirements. In such a case, the delegate of the third party would therefore need to segregate the assets of the third party's clients from its own assets and from the assets of the third party in such a way that they can at any time be clearly identified as belonging to clients of a particular third party.

This provides for a clear rule without any obvious substantive alternative option. While one could consider either to impose stronger obligation (e.g. to require individual segregation of assets of depositary's clients) or to impose less strict obligation (e.g. assets would not need to be identified as belonging to clients of a particular third party) but such options would not be consistent with Level 1 that only allows further delegation under the same conditions.

- **Issue 16 – Loss of financial instruments**

Article 21, paragraph 11; implementing powers, Article 21, paragraph 15:

Dealt with in detail in the body of the IA report

- **Issue 17 - External events beyond reasonable control**

Article 21, paragraph 11; implementing powers, Article 21, paragraph 15:

Dealt with in detail in the body of the IA report

- **Issue 18 – Objective reason to contract a discharge**

Article 21, paragraph 12; implementing powers, Article 21, paragraph 15:

The depositary's liability is not be affected by any delegation. However, in case of a loss of financial instruments held in custody by a third party, provided that there is a written contract between the depositary and the AIF, or the AIFM acting on behalf of the AIF, which expressly allows such a discharge under the explicit condition precedent of the existence of a written contract and which establishes the objective reason to contract such a discharge.

Delegated acts should specify the conditions and circumstances under which there is an objective reason to contract a discharge.

Assessment of IA need

The decision to invest into assets of a particular country is the choice of the AIFM who is bound to follow the investment mandate and the AIF rules or instruments of incorporation. For the reason for the depositary to discharge of its liability to be objective, it must be external to the depositary decision to delegate the custody function to an entity in the third country. As a consequence, the objective reason can only conceivably be linked either to a legal requirement of the third country or inability for the AIFM to follow its investment mandate and therefore the best interest of the AIF. No other substantive alternatives/options have been identified which would be consistent with the requirements of the Level 1 text. As a result, this issue is not assessed in the main body of this impact assessment.

- **Issue 19 – Depositary functions**

Article 21, paragraphs 6 to 8; implementing powers, Article 21, paragraph 17:

The assets of the AIF, or, as the case may be, the AIFM acting on behalf of the AIF, shall be entrusted to the depositary for safe-keeping, as follows:

(a) Financial instruments that can be held in custody

(i) The depositary shall hold in custody all financial instruments that can be registered in a financial instruments account opened in the depositary's books and all financial instruments that can be physically delivered to the depositary;

(ii)For this purpose, the depositary shall ensure that all those financial instruments that can be registered in a financial instruments account opened in the depositary's books, are registered in the depositary's books within segregated accounts in accordance with the principles set forth in Article 16 of Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive, opened in the name of the AIF or, as the case may be, the AIFM acting on behalf of the AIF, so that they can at all times be clearly identified as belonging to the AIF in accordance with the applicable law.

(b) Other assets

(i) For all other assets of the AIF, the depositary shall verify the ownership of the AIF, or, as the case may be, the AIFM acting on behalf of the AIF, of such assets and shall maintain a record of those assets for which it is satisfied that the AIF, or, as the case may be, the AIFM acting on behalf of the AIF, holds the ownership of such assets;

(ii) The assessment whether the AIF, or, as the case may be, the AIFM acting on behalf of the AIF, holds the ownership shall be based on information or documents provided by the AIF or the AIFM and, where available, on external evidence;

(iii)The depositary shall keep this record up to date.

In addition to the tasks referred to above, the depositary shall:

(a) ensure that the sale, issue, re-purchase, redemption and cancellation of shares or units of the AIF are carried out in accordance with the applicable national law and the AIF rules or instruments of incorporation;

(b) ensure that the value of the shares or units of the AIF is calculated in accordance with the applicable national law and the AIF rules or instruments of incorporation and procedures;

(c) carry out the instructions of the AIFM, unless they conflict with the applicable national law or the AIF rules or instruments of incorporation;

(d) ensure that in transactions involving the AIF's assets any consideration is remitted to the AIF within the usual time limits;

(e) ensure that an AIF's income is applied in accordance with the applicable national law and the AIF rules.

Delegated acts should specify the conditions for performing the depositary functions, including:

- o the type of financial instruments that shall be included in the scope of the depositary's custody duties;

Assessment of IA need

Dealt with in detail in the body of the IA report

- o the conditions upon which the depositary may exercise its custody duties over financial instruments registered with a central depositary;

Assessment of IA need

Similar rules exist already in Article 16 of implementing MiFID Directive (2006/73/EC) which imposes requirements on safeguarding of client financial instruments and funds. As there were no substantial alternative options and no obvious reason to deviate substantially from the rules in MiFID, there was also no need to for a detailed IA.

- o the conditions upon which the depositary shall safe keep the financial instruments issued in a nominative form and registered with an issuer or a registrar;

Assessment of IA need

As regards depositary safekeeping duties pursuant point (b) of paragraph 8, substantive options were identified with respect to the depositary duty to keep its record up-to-date. Those options are largely the same to those discussed under depositary cash monitoring duties, namely mirroring of all transactions, verification of procedures or enhanced verification of procedures. The options would have the same benefits and downsides as discussed under the section on "cash monitoring" duties and their assessment would therefore be repetitive and provide little additional value.

TRANSPARENCY REQUIREMENTS

- o **Issue 20 - Article 22 Annual report**

Article 22, paragraph 2; implementing powers, Article 22, paragraph 4:

The annual report shall at least contain the following:

(a) a balance-sheet or a statement of assets and liabilities;

(b) an income and expenditure account for the financial year;

(c) a report on the activities of the financial year;

(d) any material changes in the information listed in Article 23 during the financial year covered by the report;

(e) the total amount of remuneration for the financial year, split into fixed and variable remuneration paid by the AIFM to its staff members, and number of beneficiaries, and, where relevant, carried interests paid by the AIF;

(f) the aggregate amount of remuneration broken down by senior management and members of staff of the AIFM whose actions have a material impact on the risk profile of the AIF.

Delegated acts should specify the content and format of the annual report. These measures shall be adapted to the type of AIF to which they apply.

Assessment of IA need

As we respect accounting standards and other EU law and as level 1 is already relatively precise, the ESMA advice seems to be straightforward and not to comprise significant impacts that would require detailed IA.

- **Issue 21 - Article 23 Disclosure to investors**

Article 23, paragraph 4 and 5; implementing powers, Article 23, paragraph 6:

AIFM have to periodically disclose to investors for each of the EU AIF it manages and for each of the AIF it markets in the European Union:

(a) the percentage of the AIF's assets which are subject to special arrangements arising from their illiquid nature;

(b) any new arrangements for managing the liquidity of the AIF;

(c) the current risk profile of the AIF and the risk management systems employed by the AIFM to manage these risks.

AIFM managing one or more EU AIF employing leverage or marketing in the European Union one or more AIF employing leverage, have to disclose on a regular basis for each such AIF:

(a) any changes to the maximum level of leverage which the AIFM may employ on behalf of the AIF as well as any right of the re-use of collateral or any guarantee granted under the leveraging arrangement;

(b) the total amount of leverage employed by that AIF.

Delegated acts should specify the disclosure obligations of AIFM, including the frequency of the disclosure. These measures shall be adapted to the type of AIFM to which they apply.

Assessment of IA need

As for the previous issue; the additional specifications at level 2 do not seem to be adding substantial new elements that were not already implicit at level 1. As no major impacts are to be expected, a detailed IA does not seem to be required.

- **Issue 22 - Article 24 Reporting obligations to competent authorities**

Article 21, paragraph 1-5; implementing powers, Article 24, paragraph 6:

Assessment of IA need

Dealt with in detail in the body of the IA report

- **Issue 23 - Article 25 Use of information by competent authorities, supervisory cooperation and limits to leverage**

Article 25, paragraph 3; implementing powers, Article 25, paragraph 9:

The AIFM must demonstrate that the leverage limits for each AIF it manages are reasonable and that it complies at all times with the leverage limits set by it. Competent authorities have to assess the risks that the use of leverage by an AIFM with respect to the AIF it manages could entail, and when it is deemed necessary in order to ensure the stability and integrity of the financial system, the competent authorities of the home Member State of the AIFM, after having notified ESMA, the ESRB and the competent authorities of the relevant AIF, should impose limits to the level of leverage that an AIFM may employ or other restrictions on the management of the AIF with respect to the AIF under its management to limit the extent to which the use of leverage contributes to the build-up of systemic risk in the financial system or risks of disorderly markets. The competent authorities of the home Member State of the AIFM should duly inform ESMA and the ESRB and the competent authorities of the AIF, of actions taken in this respect, through the procedures on supervisory co-operation.

Delegated acts should set out principles specifying the circumstances in which competent authorities exercise these provisions, taking into account different strategies of AIF, different market conditions in which AIF operate and possible pro-cyclical effects following from exercising the provisions.

Assessment of IA need

This requirement for specification is difficult to comply with as the types of AIFM are so diverse that it would not be possible to come up with a detailed description of circumstances for each type of AIFM. It is also inherently difficult to impact assess circumstances in abstract terms, the more so as the remaining option is a more principles-based approach.

The level 1 empowerment is 'only' to establish principles to specify circumstances. The general nature of such principles on circumstances has to be of such a general nature that the margin of error in the assessment of options would be much wider than the differences between the expected impacts of the options.

SUPERVISION

- **Issue 24 - Cooperation arrangements between European competent authorities and the authorities of third countries**

There are a number of provisions in the AIFMD that require the existence of cooperation arrangements between European competent authorities and supervisory authorities from the country of origin of the non-EU AIFM or non-EU AIF. The aim of these arrangements is to ensure, in certain circumstances not limited to, an efficient exchange of information that allows the competent authorities to carry out their duties in accordance with the Directive.

The different situations where cooperation arrangements are needed can be divided into two groups: a first group would be composed by the cooperation arrangements required for the management and the marketing of non-EU AIF under the 'national regimes' (Articles 34(1), 36(1) and 40(1)). In this case level 2 measures should be adopted as soon as possible, taking into account that the authorities will have to conclude the cooperation arrangements before the end of the AIFMD transposition period (beginning 2013). The second group would include the cooperation arrangements that form part of the third country AIFM passport regime (Articles 35(2), 37(7)(d) and 39(2)(a)). Since in this case the passporting regime will only be operational by 2015, the level 2 measures could be adopted at a later stage, allowing for the timely conclusion of the arrangements before 2015.

Issue 24a) Cooperation arrangements between European competent authorities and the authorities of third countries required by Articles 34(1), 36(1) and 40(1) AIFMD

Cooperation arrangements have to be concluded between EU and non-EU competent authorities in three situations:

<u>EU AIFM managing non-EU AIF which are not marketed in Member States</u>: Appropriate cooperation arrangements are in place between the competent authorities of the home Member State of the AIFM and the supervisory authorities of the third country where the non-EU AIF is established in order to ensure at least an efficient exchange of information that allows competent authorities of the home Member State of the AIFM to carry out their duties according to this Directive.

Delegated acts should be proposed regarding the cooperation arrangements to design a common framework to facilitate the establishment of those cooperation arrangements with third countries.

<u>EU AIFM marketing non-EU AIF in Member States without a passport</u>: Appropriate cooperation arrangements for the purpose of systemic risk oversight and in line with international standards are in place between the competent authorities of the home Member State of the AIFM and the supervisory authorities of the third country where the non-EU AIF is established in order to ensure an efficient exchange of information that allows competent authorities of the home Member State of the AIFM to carry out their duties according to this Directive.

Delegated acts should be proposed regarding the cooperation arrangements to design a common framework to facilitate the establishment of those cooperation arrangements with third countries.

<u>Non-EU AIFM marketing EU or non-EU AIF in Member States without a passport</u>: Appropriate cooperation arrangements for the purpose of systemic risk oversight and in line with international standards are in place between the competent authorities of the Member State where the AIF are marketed, insofar applicable, the competent authorities of the EU AIF concerned and the supervisory authorities of the third country where the non-EU AIFM is established and, insofar applicable, the supervisory authorities of the third country where the non-EU AIF is established in order to ensure an efficient exchange of information that allows competent authorities of the relevant Member States to carry out their duties according to this Directive.

Delegated acts should be proposed regarding the cooperation arrangements to design a common framework to facilitate the establishment of those cooperation arrangements with third countries.

Issue 24b) Cooperation arrangements between European competent authorities and the authorities of third countries required by Articles 35(2), 37(7)(d) and 39(2)(a) of AIFMD

There should be cooperation arrangements between EU and non-EU competent authorities in place in three situations:

<u>EU AIFM marketing non-EU AIF with passport in the EU</u>: Appropriate cooperation arrangements are in place between the competent authorities of the home Member State of the AIFM and the supervisory authorities of the third country where the non-EU AIF is established in order to ensure at least an efficient exchange of information that allows the competent authorities to carry out their duties according to this Directive.

Non-EU AIFM authorised to manage EU AIF and or market AIF in the EU with a passport: Appropriate cooperation arrangements are in place between the competent authorities of the Member State of reference, the competent authorities of the EU AIF concerned and the supervisory authorities of the third country where the non-EU AIFM is established in order to ensure at least an efficient exchange of information that allows the competent authorities to carry out their duties according to this Directive.

Non-EU AIFM marketing in the EU non-EU AIF with passport: Appropriate cooperation arrangements are in place between the competent authorities of the Member State of reference and the supervisory authority of the third country where the non-EU AIF is established in order to ensure at least an efficient exchange of information that allows the competent authorities to carry out their duties according to this Directive.

Delegated acts should be proposed regarding the cooperation arrangements to design a common framework to facilitate the establishment of those cooperation arrangements with third countries.

Assessment of IA need

These cooperation arrangements are of great importance for the functioning of the third country passport and the achievement of the objectives of the AIFMD. Only if the rules can be effectively applied to non-EU AIF/AIFM, objectives like investor protection and systemic risk oversight but also adequate choice between investment propositions and a level playing field between EU and non-EU AIFM can only be achieved if non-EU entities active in the EU are properly regulated and supervised. These implementing measures, however, set only the framework for the arrangements themselves. They are not supposed to be blueprints to be filled in by CAs. The empowerment is not to design a template but only a common framework. The general nature of such a framework does not lend itself to develop relevant options and to assess the differences between them.

- **Issue 25: Cooperation and exchange of information between competent authorities**

A consequence of the passport for AIFM is that close cooperation between competent authorities in the supervision of AIFM that operate on a cross-border basis in the EU is essential. Competent authorities have a general obligation to cooperate with each other and with the ESMA and the ESRB whenever necessary for the purpose of carrying out their duties under the Directive or of exercising their powers under this Directive or under national law. They shall immediately supply one another and ESMA with the information required for the purposes of carrying out their duties under this Directive.

In the context of interconnected financial markets it is essential to have an adequate flow of information between competent authorities about the potential systemic consequences of the AIFM activity under their surveillance. This information should also be shared with ESMA and the European Systemic Risk Board. This is why, in accordance with Article 51(3),

The competent authorities of the Member States responsible for the authorisation and/or supervision of AIFM have to communicate information to the competent authorities of other Member States where this is relevant for monitoring and responding to the potential implications of the activities of individual AIFM or AIFM collectively for the stability of systemically relevant financial institutions and the orderly functioning of markets on which AIFM are active. The European Systemic Risk Board (ESRB) and the ESMA have also to be informed and have, in turn, to forward this information to the competent authorities of the other Member States.

Delegated acts should specify the content of the information to be exchanged; and implementing measures should specify the modalities and frequency of the information to be exchanged.

Assessment of IA need

These implementing measures on the cooperation between CA of MS are rather procedural issues and do not require a detailed IA.

This exchange of information will be electronically. The content could at maximum be the information provided by the AIFM under the reporting requirements. The only option would be to eliminate some of the reporting items from the exchange. With regard to the content of the information to be exchanged, the differences between possible options could not be determined in detail but would be marginal anyway as they would in fact only consist in the additional IT storage capacity that would be needed for the option with a larger content. Therefore, no detailed IA work seems to be required.

- **Issue 26: Authorisation of non-EU AIFM**

Non-EU AIFM will be entitled to operate in the EU in the same way as EU AIFM, provided they comply with the rules of the AIFMD and receive an authorisation from the competent authority of a Member State. The fact that these entities are established in a third country implies that the authorisation procedure has to be adapted to accommodate this reality. The AIFMD lays down criteria to determine the Member State that will act as the home Member State for each non-EU AIFM ("Member State of reference"). There could be situations where several Member States could qualify at the same time for that responsibility.

Implementing measures should specify the procedure to be followed by the possible Member States of reference when determining the Member State of reference among each other in such cases.

Assessment of IA need

As the framework of this procedure is already relatively precisely stipulated in the level 1 Directive, the differences between options would be marginal and therefore not require an impact assessment.

Annex 8: How problems could evolve with regard to the various issues

Issue 1, calculation of the assets under management: without further specification this calculation could be done differently by different AIFMs. Inappropriate calculation methods could lead to circumvention of the Directive putting in question the achievement of the objectives of regulation and appropriate prudential supervision of all actors in financial markets and of appropriate investor protection.

Issue 2, calculation of leverage: no action would mean that AIFM would continue using a multitude of methods to calculate leverage in their AIF. Leverage figures reported by AIFM could not be compared. This would make it difficult if not impossible for investors to compare and assess the risk profiles of AIF and for supervisors to monitor funds and markets effectively. This would represent a higher risk for investors and leveraged AIF could have a strong influence on markets and ultimately even create systemic risks without supervisors necessarily becoming aware of it.

Issue 3, additional own funds: without further specification there would be a risk that AIFM hold insufficient coverage to ensure investor protection. This could also lead to regulatory arbitrage. Inconsistencies in the application of capital requirements could incentivise AIFM to locate in MS with lower requirements and investors would have difficulties to assess the safety of their investments.

Issue 4, scope of custody: the lack of a common understanding on which financial instruments are to be held in custody could pose the risk that different interpretations on the scope of custody emerge among different national rules and regulations that transpose the AIFMD. This in turn could lead to differences in the level of investor protection, in particular through differences in the depositary's liability to return assets in case of their loss.

Issue 5, "external event": different interpretations of this core notion by national authorities and courts could result in a lack of a uniform level of investor protection in case an asset in custody is lost.

Issue 6, cash monitoring: materially different degrees of intensity of monitoring of AIF’s cash flows could lead to inconsistencies in or inappropriateness of depositary duties to the detriment of investors.

Issue 7, reporting to competent authorities: without sufficient and timely information supervisors might not be in the position to properly monitor macro-prudential (systemic) risks and of risks to market efficiency and integrity; or to oversee that AIFM properly address micro-prudential risks, e.g. with regard to risk and liquidity management. This would also jeopardise investor protection.

Annex 9: Problem drivers, problems addressed, and objectives for the key issues

Table A9.1: Issue 1: Calculation of assets under management

	Problem Drivers	Problems addressed	Operational objectives
Level 1:	• Inability to take immediate, coordinated and appropriate action	• Regulation, authorisation and macro-prudential supervision of AIFM	• Ensure that all AIFM satisfy specific requirements
Level 2:	• High level rules at level 1 allow AIFM to use different methods to follow own agendas	• Circumvention of the Directive • Regulatory arbitrage	• Ensure that calculation of leverage does not allow AIFM circumventing regulation
Level 1:	• Excessive reliance on counterparties and trend-following at the expense of sound risk management and due diligence	• Micro-prudential risks	• Ensure proper risk management controls (market, liquidity, counterparty and operational risks)
Level 2:	• High level rules at level 1 allow AIFM to avoid full application of AIFMD rules on fund management	• Ineffective supervision of AIFM	• Ensure effective risk reduction and precaution
Level 1:	• Unexpected adverse effects on investors	• Investor protection	• Reduce weakness in investor disclosures; • Ensure proper management of conflicts of interest; Ensure appropriate controls and processes in key risk areas
Level 2:	• High level rules at level 1 allow AIFM to avoid full application of AIFMD rules on investor protection	• Investors not benefitting from protection provided by AIFMD for AIFM circumvent it • Ineffective supervision of AIFM	• Ensure that investors benefit from protection provided by AIFMD for all AIFM covered by the AIFMD and that all these AIFM are effectively supervised

Table A9.2: Issue 2: Calculation of leverage

	Problem Drivers	Problems addressed	Operational objectives
Level 1:	- Inability to take immediate, coordinated and appropriate action - Lack of information did not allow swift action by supervisors - Extensive use of leverage creates or exacerbates risks for investors but also for counterparties and therefore potentially the financial system as a whole	- Regulation, authorisation and macro-prudential supervision of AIFM	-Ensure that all AIFM satisfy specific requirements - Ensure transparency of AIFM activity, effective monitoring of systemic risks - Ensure that relevant macro-prudential data is timely shared at EU level
Level 2:	- High level rules at level 1 allow AIFM to use different methods to follow own agendas - Use of different methods by AIFMs might mask the build-up of risks in markets	- Circumvention of the Directive - Regulatory arbitrage - Ineffective/insufficient monitoring of AIFM and their activities	- Ensure that calculation of leverage does not allow AIFM circumventing regulation - Ensure that supervisors are provided with relevant information in a format that allows it to be disseminated and aggregated in a timely manner
Level 1:	- Unexpected adverse effects on investors	- Investor protection	- Reduce weakness in investor disclosures; - Ensure proper management of conflicts of interest; - Ensure appropriate controls and processes in key risk areas
Level 2:	- Investors could invest in AIF that are higher leveraged than they seem and thereby bear unintended risks	- Investors not able to compare and assess the risk profiles of AIF - Investors not benefitting from IP provided by AIFMD for that circumvent it - Ineffective supervision of AIFM	- Ensure that information is comparable across Member States and similar AIFM/AIF
Level 1:	- Extensive use of leverage creates or exacerbates risks of adverse impacts on markets in which leveraged AIFM are active	- Market efficiency	- Remove barriers to efficient cross-border marketing of AIF to professional investors without compromising effectiveness of regulation and supervision
Level 2:	- Unrevealed levels of leverage could lead to the build up of risks in certain markets without supervisors being able to monitor properly	- Ineffective supervision of AIFM and monitoring of AIFM activities in specific markets	- Investors to be provided with comparable information about AIF marketed in the EU balancing the need for harmonisation and flexibility - Supervisors to be provided with appropriate and comparable information about AIFM activities

Table A9.3: Issue 3: Additional own funds

	Problem Drivers	Problems addressed	Operational objectives
Level 1:	- Investors risk losing money or might not be able to recover their investments at their discretion	- Investor protection	- Reduce weakness in investor disclosures - Ensure proper management of conflicts of interest; - Ensure appropriate controls and processes in key risk areas
Level 2:	- AIFM might hold only low levels of additional own funds or PII so that investors might still risk loosing money or not being able to redeem at their discretion	- Insufficient precaution regarding operational risks - Risk of regulatory arbitrage or a non level playing field	- Ensure that AIFM hold sufficient own funds or PII coverage for operational risks

Table A9.4: Issues 4-6: Depositary

	Problem Drivers	Problems addressed	Operational objectives
Level 1:	- Very diverse approaches to depositary rules across Member States and types of AIFM resulting in very different (and sometimes low) levels of investor protection and legal uncertainty	- Investor protection	- Reduce weakness in investor disclosures - Ensure proper management of conflicts of interest; Ensure appropriate controls and processes in key risk areas
Level 2:	- AIFMD does not provide an exhaustive list of the types of financial instruments that can be registered on an account opened in the depositary's books - As there is no established definition of an 'external event' at EU level, there would be legal uncertainty and a risk of diverging interpretations across Member States - AIFMD does not specify the general requirements of depositary duty with respect to monitoring of AIF's cash flows. - There would be legal uncertainty and a risk of diverging levels of monitoring efforts across Member States	- Lack of a common understanding on which financial instruments are to be held in custody under which circumstances resulting in risk of different interpretations on the scope of custody and differences in the level of investor protection across Member States - Materially different degrees of intensity of monitoring of cash flows could lead to inconsistencies in or inappropriateness of depositary duties to the detriment of investors	- Define scope of custody of financial instruments in a uniform way - Define what an 'external event' is with respect to depositary liability - Ensure that cash flows are properly monitored by the depositary

Table A9.5: Issue 7 and 8: Reporting to competent authorities / Substantial level of leverage

	Problem Drivers	Problems addressed	Operational objectives
Level 1:	- Inability to take immediate, coordinated and appropriate action	– Macro-prudential risks, use of leverage	- Ensure transparency of AIFM activity, effective monitoring of systemic risks Ensure that relevant macro-prudential data is timely shared at EU level
Level 2:	- Problem driver at level 1 only partly addressed	– Ineffective/insufficient monitoring of AIFM and their activities	- Ensure that supervisors are provided with relevant information in a format that allows it to be disseminated and aggregated in a timely manner
Level 1:	– Unexpected adverse effects on investors	– Investor protection	- Reduce weakness in investor disclosures - Ensure proper management of conflicts of interest; - Ensure appropriate controls and processes in key risk areas
Level 2:	– Problems at the level of AIFM in the implementation of investment strategies noted only at a late stage	– Ineffective supervision of AIFM	– Ensure that supervisors have up-to-date information to control that AIFM comply with the investment strategies and rules of the AIF they manage
Level 1:	- Risk of adverse impacts on markets in which AIFM are active	- Market efficiency	- Remove barriers to efficient cross-border marketing of AIF to professional investors without compromising effectiveness of regulation and supervision
Level 2:	- Risk of adverse impacts on markets in which AIFM are active persists if supervisors get information too late	- Ineffective supervision of AIFM and monitoring of AIFM activities in specific markets	- Ensure that supervisors have up-to-date information to control that AIFM not adversely affect the functioning of AIF and other markets

Annex 10: Related Commission proposals

As the AIFMD does not cover and does not provide an appropriate framework for the marketing and management of venture capital funds (VCF) and social investment funds (SIF) with assets under management below the thresholds of Article 3 AFIMD, the European Commission proposed specific regulatory frameworks for these types of fund which are briefly described below.[42] The crucial point to mention here is that the vast majority of managers of both types of fund remain far below the threshold of the AIFMD. Although these managers would nevertheless have the option to opt-in and seek authorisation under AIFMD, the requirements of the Directive were not seen as fully suitable for small managers of these types of AIF. Therefore, separate legislative initiatives have been proposed by the Commission.

Proposal on European Social Entrepreneurship Funds
The proposal sets out a new "European Social Entrepreneurship Fund" label, so investors can easily identify funds that focus on investing in European social businesses. The approach is simple: once the uniform requirements defined in the proposal are met, managers of social entrepreneurship funds will be able to use the new label and market their funds across the whole of Europe. Every fund using the label will have to prove that a high percentage of investments (70% of the capital received from investors) are spent in supporting social businesses. Uniform rules on disclosure will ensure that investors get clear and effective information on these investments.

Social businesses have taken a business form to access private finance, but they still can find it hard getting the finance they need to grow. Investment funds are key to filling this gap. However, investment funds currently face challenges doing this. Two problems have emerged.
• The first problem is that the funds can find it costly and difficult to set themselves up and gather investments, particularly from investors in Member States other than one in which they are based. This limits the size and efficiency of the funds, and reduces the options for investors across Europe.
• The second problem is to do with information: funds which concentrate on investing in social businesses are not always easy to identify, and it can be confusing comparing the advantages of different funds or working out how effective a particular investment might be. Currently lots of different ways of presenting the aims and achievements of such funds exist.

The proposed regime should bring a number of improvements. Firstly, social businesses will get easier access to private finance, helping support their growth. This will benefit many ordinary citizens: creating inclusive and sustainable jobs and growth across Europe. Secondly, professional investors will find it easier to identify and choose funds that are targeting investments in social businesses. Thirdly, investment funds managers will find it less costly and complex to raise funds, including cross-border.

The AIFMD is not the appropriate tool to achieve these effects as social entrepreneurship funds (SEF) are much smaller than the funds targeted by the AIFMD. Estimates of the size of

[42] Further information can be found on the Commission website.: http://ec.europa.eu/internal_market/investment/social_investment_funds_en.htm and http://ec.europa.eu/internal_market/investment/venture_capital_en.htm

the EU market for SEF vary, but current 'best estimates' by the European Investment Fund (EIF) are that there are around 50 funds verified by them as focusing on social businesses, though they note this could extend up to around 200. The average size of the funds is very small – between EUR 10 and 20 million – with only one or two exceptions (e.g. BridgesVentures in UK, which is around EUR 115 million). A rough estimate based on these fund sizes and numbers of funds therefore gives a market that could be of around EUR 500 million to around EUR 4000 million.

Proposal on Venture Capital Funds

Venture capital (VC) funds are operators that provide mostly equity finance to companies that are generally very small, in the initial stages of their corporate development, but often innovative and demonstrating a strong potential for growth and expansion. In the EU, venture capital funding displays high potential benefits for the development of small- and medium-sized enterprises (SMEs).

Despite years of policy initiatives that promote venture capital, compared to other sectors of the European investment funds industry, venture capital remains a niche sector. The venture capital sector in Europe is small compared to the broader sector of 'private equity'. Within the broad range of private equity investors, venture capitalists account for between 10% and 15%, depending on the chosen year of reference. As at the end of 2010 there were about 1,500 private equity managers headquartered in the European Union. In aggregate, these managers accounted for € 500 billion of assets under management.32 Exactly 10% of this amount, approximately € 50 billion, can be attributed to the venture capital funds.

The average European VC Fund size is around € 60 million. This situation is also borne out when assessed from the perspective of the overall portfolio of venture capital funds managed by a particular fund manager. According to the latest figures available from the European Private Equity and Venture Capital Association (EVCA), 98% of European venture capital fund managers manage a portfolio of funds that would be beneath the € 500 million threshold set out in the Directive on Alternative Investment Fund Managers (AIFMD).

Annex 11: Determination of the multiplication factor for additional own funds/PII

3rd step: Determination of the multiplication factor for additional own funds/PII

After having determined the basis from which to calculate the additional own funds or PII, the last step is the determination of the multiplication factor that has to be applied to the total assets under management in order to determine the actual amount of additional own funds or PII coverage. Here the question arises whether the same factor should be applied to additional own funds and to PII. As additional own funds are readily available while PII are to a certain extent uncertain because the insurance might claim that the claim was not valid. Therefore, the multiplication factor for PII is for example higher by a factor of 30 for aggregate claims in a given year (and a factor of 20 for individual claims) in the UK for a similar purpose and ESMA also proposed different approaches. The discussion of this third step is therefore split between additional own funds and PII; without excluding already at this stage that the conclusion might nevertheless be to apply the same multiplication factor to both.

In theory this multiplication factor could be set anywhere between 0 and 1. A factor of zero would matter-of-factly result in option 1 of step 1, namely 'do nothing'. This, however, was not a viable option. Therefore, the factor has to be greater than zero. Any factor above 0,1 or 10% would seem disproportionately high as the "Basic Indicator Approach" used in Directive 2006/48/EC relating to the taking up and pursuit of business of credit institutions is at 15% but covers a much wider range of risks. Furthermore, it has to be taken into account that, as already mentioned above, the additional own funds discussed here are already the third layer of funds after the initial capital and the additional own funds required by Article 9(3) AIFMD.

As no factual evidence is available it is not possible to draw up a substantiated analysis determining the appropriate factor. Therefore, only the approach presented by ESMA will be discussed for additional own funds and PII.

With regard to additional own funds ESMA proposes that additional own funds should equal 0.01% of the value of the portfolios of AIFM managed by the AIFM.[43] In view of the above discussion regarding the capital adequacy Directive and the multiple layers of funds this factor seems reasonable.

With regard to PII coverage, ESMA proposes that the minimum coverage per claim should at least equal the higher of (a) 0.75% of the amount by which the value of the portfolios of AIFM managed by the AIFM exceeds €250million, up to a maximum of €20 million; (b) €2 million.

With regard to the minimum coverage in aggregate per year ESMA proposes that it should at least equal the higher of (a) 1% of the amount by which the value of the portfolios of AIFM managed by the AIFM exceeds €250million, up to a maximum of €25 million; (b) €2.5 million.

It is striking that ESMA proposes both a minimum coverage and a maximum amount for PII coverage while it did neither of the two for additional own funds. The only justification given in the explanatory text of the advice is that this part (a) mirrored Article 9(3) AIFMD and (b)

[43] Box 7 of ESMA advice, p. 33.

followed MiFID. There is no explanation why these consideration have not been taken into account for the additional own funds.

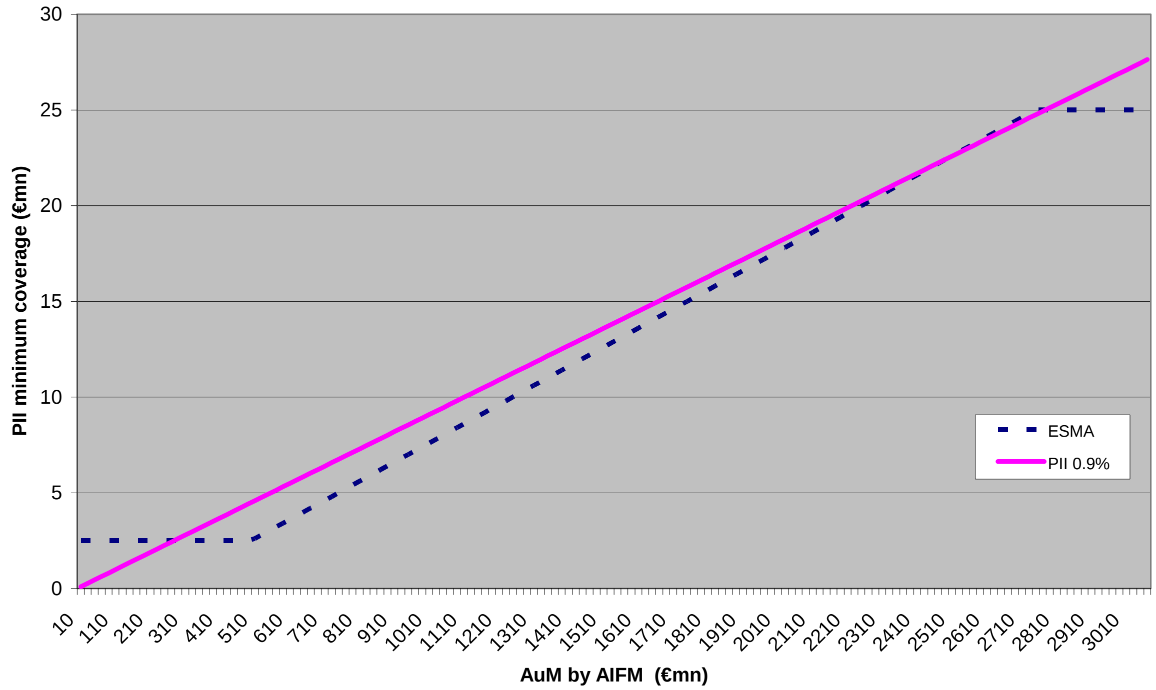
The absolute minimum amount might make sense if there were not the additional own funds of Article 9(3) AIFMD already. But as they already exist, this minimum would put a relatively higher burden on AIFM managing portfolios up to €500 million. Furthermore, it would be particularly burdensome for small AIFM who want to opt-in under Article 3.

The maximum amount of €25 million or €20 million, respectively, would favour AIFM managing portfolios of more than €2750 million.

Reference to national rules in Member States does not provide any useful solution either as a survey of Member States' rules revealed that national requirements do not go beyond what is already required by Article 9(3). Of the 18 Member States that have replied to the survey, none applies such 'additional additional own funds'.

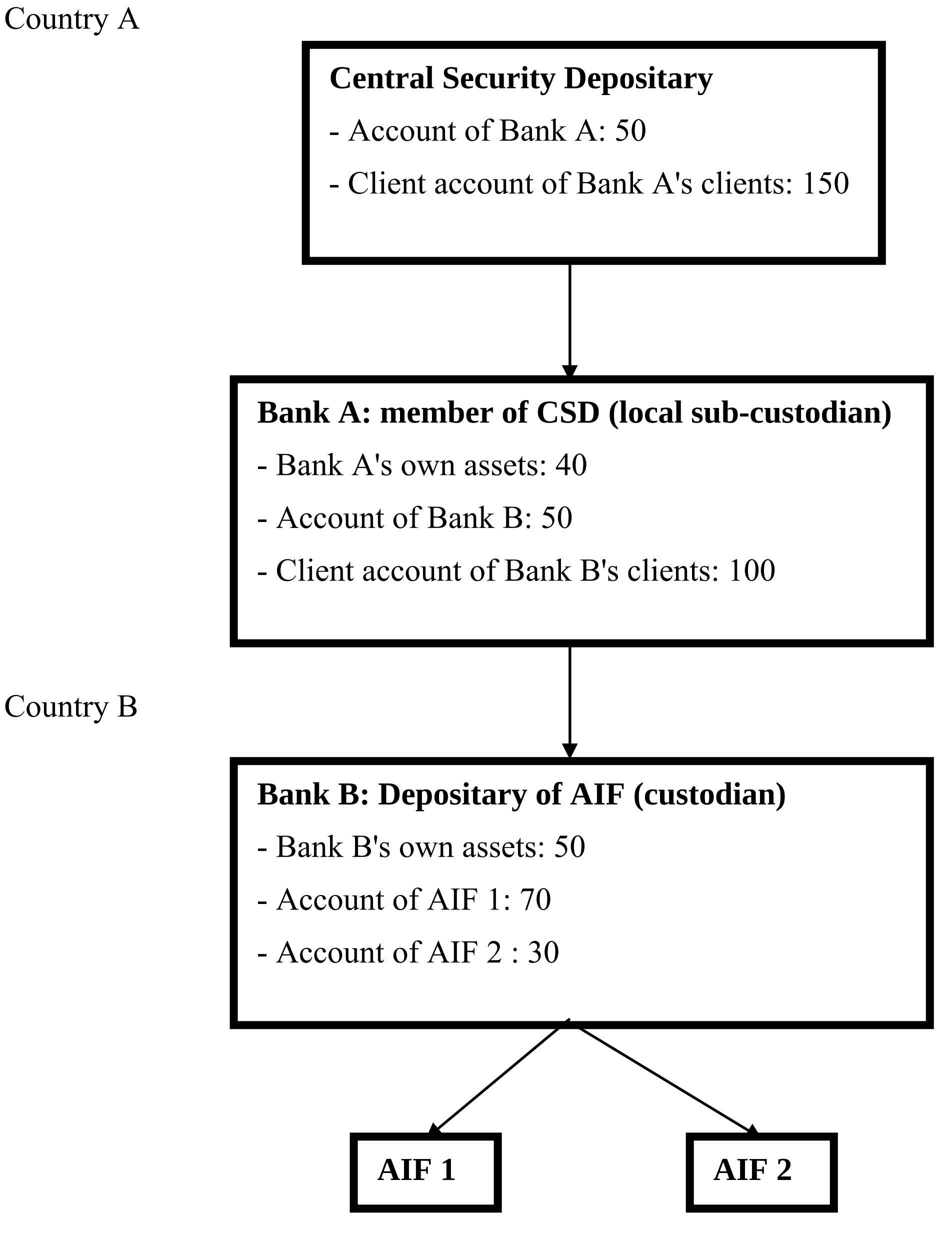
It therefore seems to be more appropriate to align the multiplier for PII with the one for additional own funds, i.e. to apply a factor without any thresholds or caps. As suppressing threshold and cap would result in significantly higher coverage the factors can be reduced to 0,9% instead of 1% of AuM for the aggregate and from 0,75% to 0,7% for individual claims.

Chart A10.1: Comparison: PII minimum coverage under ESMA proposal and preferred option



Annex 12: Illustration of a typical custody chain

The following diagram shows a typical custody chain. As an illustrative example, an issuer issues 200 units of financial instruments through the local Central Security Depositary. The instruments have been purchased by Bank A, Bank B, AIF 1 and AIF2. The depositary (Bank B) of AIF 1 and AIF 2 is domiciled in Country B. The depositary does no have its own subsidiary in Country A and therefore uses (i.e. delegates custody to) the local sub-custodian (Bank A) to access the local CSD.



Annex 13: Example of the total asset and leverage calculation for a derivative

The example below describes the exposure created by the acquisition of a call option on the underlying index DJ Euro STOXX 50. It then compares how this call option would be valued if it was marked-to-market and if it was valued on the basis of the value of the underlying.

A call option gives the right to the buyer to buy the underlying asset, here the Euro STOXX 50 index, at a predetermined price ('strike price') and date ('expiration date'). The owner will exercise his right at the expiration date, if the price of the index is above the strike price, because then he can get the asset/index for less than when he would buy it on the market. If the price is below the strike price, he will not exercise the option but will buy the asset/index on the market. The option mechanism gives the opportunity to the option holders to gain large exposure with low invested amounts.

Table 13.1: Call option on DJ Euro STOXX 50 (market data of 15.02.2012):

Strike price:	2.500€
Expiration date:	20.04.2012
Call price:	99,60€
Contract size:	10
Delta*:	0,54
Market value of DJ Euro STOXX 50 index:	2'510,13€

* When the index price moves by 1%, the option price moves in the same direction by 0,54%

With this option, the owner potentially holds 10 units in the DJ Euro STOXX 50.

The market value of the option therefore is: 10x 99,60€;

The potential exposure equals 10 units of a price of 2510,13€ and with a delta weighing of 0,54, i.e. 10 x 2510,13 x 0,54 = 13.554,70€.

The leverage in the option calculated with the gross method equals the exposure divided by NAV in this simplistic example of only one asset which is a derivative: 13.554,70/996,00 = 13,6

Table 13.2: Total asset calculation and leverage

AuM of the option if valued at its market price:	996,00€
AuM of the option if valued at the value of the underlying:	13.554,70€
Leverage embedded in the option:	13,6

This example shows that buying 10 calls for a price of €996,00 gives a equivalent exposure in the underlying index of €13.554,70.

Annex 14: Feedback on the ESMA consultations

1. ESMA consulted on its draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive (AIFMD) by means of two separate consultation papers (CPs). The first covered Parts I to III of the Commission's request for assistance and was published on 13 July 2011 (ESMA/2011/209). The second, covering Part IV of the Commission's request, was published on 23 August 2011 (ESMA/2011/270). ESMA received 104 and 49 responses to the two CPs respectively. Feedback was provided by alternative investment fund managers and depositaries (and their associations), institutional investors and other regulatory authorities.

General comments

1. A number of general comments were made on the advice. Some respondents welcomed the consistency that had been achieved with UCITS and MiFID. Others felt that a principles-based approach should be favoured as much as possible. One investment management association also called for the Level 2 provisions to be designed with professional investors in mind.

2. Some more negative points were made with respect to the advice as a whole. One association stressed that ESMA should pay close attention to remaining within the scope of the Commission's request (c.f. Box 19 on delegation or the Transparency requirements) and felt that some of the boxes lacked clarity and would benefit from introduction of the explanatory text into the box. One institutional investor representative went further, stating that in some areas of the advice, the wording made compliance almost impossible to achieve and should be reconsidered (e.g. the requirement in paragraph 1 of Box 26 to identify all relevant risks to which the AIF might be exposed). Two investment management associations considered, meanwhile, that the draft advice had been prepared with externally-managed AIFs in mind and was not always suitable for internally-managed AIFs.

3. There were a number of requests for greater proportionality and differentiation, whether in general or in relation to specific areas such as the requirements on additional own funds and reporting obligations. Private equity representatives stressed the need to take account of private equity (PE) funds, while real estate representatives made similar requests for real estate (RE) funds.

4. Looking further ahead, two respondents expressed their view that the implementing measures should take the form of directives, perhaps with the exception of the reporting requirements to competent authorities (CAs). As for the work to be done on the technical standards required under Article 4(4) of the Directive, one investment management association encouraged ESMA to seek industry input to its work on developing a typology of AIFs.

5. Two RE associations requested an explicit statement from ESMA and/or the Commission that the Directive does not apply to property companies.

6. Part III: Article 3 exemptions

Box 1[44]

1. Several respondents agreed that the appropriate approach to calculating assets under management was to identify those AIFs for which managers was the AIFM and then to aggregate the asset under management of those AIF. Respondents also agreed that AIFM should exclude from the assets under management calculation crossholdings in other AIFs managed by the same AIFM.

2. Several respondents proposed that a period of 3 months for qualifying a situation of temporary nature was too short and should be extended to 6 months.

3. It was also suggested by some contributors that notifications to competent authorities should only be sent when AIFM believe that the situation of assets under management above the threshold was not a situation of a temporary nature.

7. ESMA's response: The suggestion made by some respondents to the public consultation to extend the period for qualifying a situation of temporary nature from 3 to 6 months was not accepted by ESMA. Indeed, ESMA believes that a period of 6 months would be too long for seeking authorisation. ESMA also disagreed with the proposal to notify competent authorities only when the situation is not of a temporary nature because competent authorities should be informed that the total value of assets under management an AIFM has exceeded the threshold even if the AIFM do not seek for authorisation after three months.

Q1: Does the requirement that net asset value prices for underlying AIFs must be produced within 12 months of the threshold calculation cause any difficulty for AIFMs, particularly those in start-up situations?

4. Most respondents did not foresee major problem with this requirement while it was indicated some difficulties may arise for start-up situations.

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

5. The vast majority of respondents to the consultation disagreed with this proposal. According to them, imposing a single date for calculation of asset under management would greatly increase the difficulty of obtaining NAV within 12 months of the relevant calculation date. Further, external resources, like external valuers, would also be unable to allocate their workforce economically.

8. ESMA's response: In light of the feedback received from the consultation, ESMA decided not to specify a single date for the calculation of the threshold.

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[44] The numbering of the Boxes in this section reflects the consultation papers published in July and August respectively, unless otherwise stated.

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.

6. Respondents to the consultation expressed mixed views on this issue. These mixed views reflected the heterogeneity of the type of AIFM and AIF that fall into the scope of the Directive.

7. According to one stakeholder, private equity and venture capital managers should be given an alternative approach. According to this stakeholder, a more appropriate method for calculating the total value of assets under management for private equity and venture capital managers would be to take the acquisition cost of all investments less the acquisition cost of investments realised and of investments that have been written off since.

8. For several respondents, the use of the NAV was not an appropriate measure for all types of AIFs due to the wide range of funds that fall into the scope of the AIFMD.

9. On the contrary, other contributors were of the view that the net asset value was an appropriate measure of asset under management which according to them necessarily reflects the value of any assets acquired through leverage. Some of these respondents agreed that for many AIFs, the net asset value was an appropriate measure but stressed that the methodologies to calculate the net asset value should be done according relevant national rules and recognised accounting standards.

9. **ESMA's response:** ESMA carefully analysed the comments received during the public consultation and decided to change the approach for the calculation of the total value of assets under management. Indeed, many respondents felt that the use of the net asset value for the calculation of the total value of assets under management would not be practicable for many AIFM investing in non-liquid or non-listed assets like private equity AIFs. Therefore, ESMA recommends that the calculation of the total value of assets under management should be based on asset valuation and does not prescribe what the methods for these valuations should be except for derivative positions. Indeed, ESMA strongly believes that derivatives positions entered into by AIFM should be converted into their equivalent position in the underlying asset of that derivative and should not be taken for their market value. Moreover, as proposed in the consultation paper, the calculation should be performed at least annually using asset value calculation that are not older than 12 months. As regards the evolution of the total value of assets under management between two annual calculations, ESMA recommends that AIFM must apply on on-going basis procedures that allow them to monitor the value of their assets under management. Therefore, AIFM should not systemically recalculate on a regular basis the total value of assets under management but rather monitor different factors like subscriptions and redemptions, capital drawdowns or the value of the assets and if, based on these observations they believe that the total value of assets under management, perform a new calculation.

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

10. One respondent noted that large managers which were fully subject to the AIFMD would only be required to value their asset under management annually (where, as is the case for private equity

and venture capital funds, they are closed ended funds which do not issue or redeem units). Therefore, this respondent suggested that the same should apply to smaller managers of closed ended funds, at least those which do not invest predominantly in 'assets that must be held in custody' and/or generally invest in issuers or non-listed companies in order to potentially acquire control. However, this contributor would accept half-yearly monitoring and proposed that private equity and venture capital AIFM should not be required to assess market fluctuations or possible changes in the value of individual assets as it was a long and complex exercise to value a private equity or venture capital asset.

11. For another respondent, an increase of the value of asset under management due to market exposure should not generally require a recalculation unless there was evidence that this was an established trend.

12. It was also pointed out that situations like large redemption orders, assets written-down or written off would be situations for which there should not be re-calculation of the value of total assets under management.

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

13. The vast majority of respondents to the consultation disagreed with this proposal and believed that AIFs which are exempt under Article 61 of the Directive should not be included when calculating the threshold.

10. **ESMA's response:** Based on the feedback received from the consultation, ESMA recommends that AIFs which are exempt under Article 61 of the AIFMD should not be included when calculating the threshold.

Box 2: Calculation of leverage

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?

14. In general, this proposal was not supported by respondents to the consultation.

15. For one respondent it was difficult to understand why for the purpose of calculating the asset under management the leverage should computed using the gross method. According to this respondent, the mere concept of taking gross exposure did not seem to fit very well with a calculation of assets under management which is generally proposed to be made on a net basis.

16. Several contributors also disagreed with the proposition to include the gross exposure in the calculation of the value of assets under management because the net asset value already includes the value of instruments acquired through leverage.

17. It was also pointed out that this proposal was not consistent with the part of the consultation paper on the calculation of leverage which allows for different methods. Also, it was stressed that including gross leverage would be misleading because investors and industry participants have a clear understanding of the term asset under management as meaning assets under management from investors. Moreover, the inclusion of gross leverage in the calculation of the total value of assets under management would bring many small AIFs and AIFMs into the Directive.

11. **ESMA's response:** ESMA decided to delete the Box 2 related to the calculation of the leverage in the final advice and to incorporate the relevant provisions in Box 1. However, as explained above, ESMA modified the approach for assets acquired through leverage. Hence, ESMA no longer recommends that AIFM should calculate the leverage according to the gross method when calculating the total value of assets under management. Instead, ESMA believes that derivatives instruments should be converted into their equivalent position in the underlying asset and added to the value of the other investments made by the AIF. Indeed, if derivative positions were treated at their market value this could lead to situations where small AIFM that extensively make use of financial derivatives instruments are not captured by the AIFMD even if their exposure to the market (after conversion of the derivative position) is the same as AIFMs which directly invest in the underlying assets and which are subject to the Directive.

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

18. A majority of respondents to the consultation were in favour of this proposal.

19. Some respondents pointed out that, if the calculation of the total value of assets under management was based on the NAV as proposed by ESMA, the value of foreign exchange or interest rate hedging positions would be necessarily reflected in the NAV of the relevant AIF.

12. **ESMA's response:** In light of the feedback received, ESMA decided to exclude from the calculation of the total value of assets under management derivative positions when they are used to for currency and interest rate hedging and are not part of the investment strategy of the AIF to generate return.

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?

20. In general respondents to the consultation felt the proposed requirements for calculating the total value of asset under management clear although many of them disagreed with the treatment of gross exposure which, according them was a different concept from the total value of asset under management.

21. Some stakeholders felt paragraph 5 too prescriptive and disagreed with the 3-month period and proposed a 12-month period instead (i.e. to wait until the next calculation).

22. ESMA was also asked to specify that for AIFM investing in physical assets, different methodologies could be used as the income value approach for instance.

13. **ESMA's response:** As explained above, Boxes 1 and 2 have been merged into a single Box 1 and the treatment of derivatives instruments clarified.

Box 3: Information to be provided as part of registration

23. Many respondents expressed some concern about the requirement to report on a quarterly basis to competent authorities.

24. It was also suggested that competent authorities should not have the possibility to request information on a more frequent basis than determined in paragraph 4 of Box 3 and therefore asked for the deletion of paragraph 5. Some stakeholders believed that the word 'at least' in paragraph 2 of Box 3 should be deleted in order to ensure a harmonisation at EU level.

25. It was also suggested that the update should be done in case of material changes to the risk profile. Otherwise a reporting on an annual basis should be enough.

14. **ESMA's response:** Based on the comments received, ESMA has decided to amend the approach and recommends in the final advice that the information under Article 3(3) (d) should be provided on an annual basis rather than on a quarterly basis as proposed in the consultation paper.

Box 4: Opt-in procedures

26. There was a general support from stakeholders on the approach proposed by ESMA for opt-in procedures.

15. **ESMA's response:** In light of the general support from respondents to the consultation, ESMA did not modify the advice concerning opt-in procedures.

Box 5: AIFMs falling below the threshold

27. There was a general support from respondents to the consultation on Box 5.

28. However, it was proposed that the provisions would be better expressed as simple requirements only to take action if the AIFM wishes to seek exemption.

16. **ESMA's response:** Following the general support expressed from respondents to the consultation, ESMA did not modify the advice concerning opt-in procedures

17.

18. **Part IV: General operating conditions**

IV.I. Possible Implementing Measures on Additional Own Funds and Professional Indemnity Insurance

General comments

29. Asset managers' and insurers' representatives expressed a general comment according to which the possible implementing measures on additional own funds and professional indemnity insurance (PII) were not appropriate for internally managed AIF and raised a number of practical questions:

    - it was unclear how the additional own funds should be raised;
    - it was unclear whether the additional own funds may be a part of the AIF's assets being invested or should be segregated from the other assets of the AIF;
    - for closed-ended internally managed AIF, it was unclear how they should raise the additional own funds or adjust them during their life.

30. The same asset managers' representatives recognised that these issues came from the provisions in Level 1 and mentioned that they could be solved by amending article 9(6) of the AIFMD to provide for a waiver from the additional own funds requirement in case they benefit from a guarantee for 100% of the additional amount of own funds.

31. As a consequence of this situation, asset managers' and insurers' representatives called for the introduction of the possibility for AIFM to use a combination of additional own funds and PII. Furthermore, asset managers' representatives requested to provide for a cap on the additional own funds reflecting the EUR 10 million's cap for the own funds.

32. Some institutional investors asked to clarify that in case of self-managed AIFs operating with a board of directors that delegates functions to qualified third parties and do not have employees per se it would be permissible to have directors' liability insurance cover rather than PII cover.

33. Some insurers' representatives mentioned that, given the limited availabilities in this market, there will likely be an inadequate amount of insurance capacity to fulfil the demand for PII that will be brought about by the AIFMD rules; whereas remaining in opposition to the requirements of Article 9 of the AIFMD, they recommended that Article 9 should remain as flexible and broad as possible so as not to unduly hinder insurance market capacity for the cover of potential claims.

    ESMA's response: ESMA saw merit in the requests for introducing the possibility to have a combination of additional own funds and professional indemnity insurance, in particular given both the inappropriateness of the additional own funds for internally managed AIFs and the claims that there would likely be an inadequate amount of insurance capacity to fulfil the demand for PII that will arise as a consequence of the new rules. ESMA advice foresees the possibility to combine the additional own funds and the PII and sets out the rules to be followed for determining the respective amount of additional own funds and coverage of PII in case of combination.

ESMA did not follow the request of introducing a cap for the additional own funds required under Article 9(7) of the AIFMD since this would have resulted in an unjustified advantage to bigger AIFMs.

ESMA considered that directors' liability insurance cover may not replace the PII cover which was prescribed to AIFM by the AIFMD.

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

34. Private equity managers encouraged ESMA to consult with the EU insurance market in order to establish whether insurers will be prepared to offer policies of the type covered by ESMA's proposal and to clarify how PII policy should be drafted in order to comply with the relevant requirements.

35. The same private equity managers asked for the introduction of a transitional period during which AIFMs would be required to obtain PII meeting the relevant requirements insofar as they are able to obtain qualifying PII in their member state or elsewhere in Europe.

36. Real estate representatives asked for specific guidance on the risks that managers of non-listed real estate funds are liable for.

37. Several asset managers were against the obligation of coverage of losses arising from all 'relevant persons', including those who provide services under a delegation agreement. Some of them mentioned that it is very difficult to implement this to the extent that the AIFM is normally not aware of all the risks of the delegate. Others suggested the replacement of the reference to 'relevant persons' with a reference to 'AIFM's staff'. Private equity managers argued that the wide definition of 'delegation' in the definition of 'relevant persons' meant that the PII would have to cover both (i) service providers for whom an AIFM has vicarious liability (i.e. third parties who act on behalf of the AIFM for which an AIFM has liability) and (ii) service providers for whom an AIFM does not have vicarious liability, whereas AIFM would be unable to purchase PII which cover persons falling under (ii); thus, they proposed to replace the reference to 'relevant persons' with a reference to 'the AIFM's directors, officers or staff or third parties for whom the AIFM has vicarious liability'.

38. In order to avoid a double coverage at the level of both the AIFM and the delegate, several asset managers asked for amending Box 6 in order to exclude the risks of the delegate if the latter holds an own sufficient indemnity insurance. Some of them and also some insurers suggested requiring AIFM to have appropriate coverage only where the loss arises due to negligence of the AIFM in appointing and supervising the delegate. Similarly, other asset managers asked to clarify that risks need not to be insured where they fall within the responsibility of a supplier who has its own insurance and requested to accordingly amend the reference to 'legal responsibility' included in the first sentence of paragraph 2 of Box 6. Certain insurers suggested that the activities for which the AIFM has 'legal responsibility' should be limited to those listed in Annex 1 of the AIFMD.

39. Several asset managers and insurers asked to delete paragraph 2(a) of Box 6 since potential liability of an AIFM should be restricted to risks arising from negligence, not including the risks arising from fraud, which are not mentioned in article 9 of the AIFMD. Private equity managers mentioned that PII can provide limited extent of cover in relation to fraud, dishonest acts and malicious acts and were of the opinion that the coverage of risks in relation to fraud was beyond the requirements of the Level 1 Directive. Insurers' representatives mentioned fraud among the perils which are traditionally assumed as uninsurable under a liability policy.

40. Some asset managers suggested amending paragraph 2(c) of Box 6 in order to align it to the current practice of the insurance industry which provides that losses resulting from mechanical failures are excluded from insurance coverage, unless the loss is a result of an intervention or manipulation of the staff of the AIFM.

41. Several asset managers requested the deletion of paragraph 2(c) of Box 6 since business disruption and system failures are not an AIFM professional negligence issue and are outside the scope of the Level 1 directive. Some of them added that these issues are already covered by paragraph 2(b) of Box 6.

42. Hedge funds managers suggested not making the requirements of Box 6 mandatory, but requiring AIFM and competent authorities to 'have regard to' the list of issues in Box 6 since in a number of EU jurisdictions (other than the UK) there is no developed market for PII for AIFMs.

ESMA's response: The suggestion made by some stakeholders to exclude the losses arising from entities providing services to the AIFM under a delegation agreement or to limit the liability of the AIFM to the cases of negligence in appointing and supervising the delegate was not taken into account. Indeed, according to Article 20(3) of the AIFMD, the liability of the AIFM shall not be affected by the fact that it has delegated functions to a third party, or by any further sub-delegation. However, ESMA agreed on clarifying that the liability of the AIFM shall be limited to the AIFM's directors, officers or staff or third parties for whom the AIFM has vicarious liability.

ESMA recognised that fraud as such is not an insurable risk and decided to clarify that the losses linked to fraud which the AIFM is responsible for are only those arising from the failure by the senior management of the AIFM to put in place procedures to prevent dishonest, fraudulent or malicious acts within the AIFM's organisation.

On the request aiming at the exclusion of the losses resulting from mechanical failures from insurance coverage, ESMA acknowledged that according to the current practice of the insurance industry such losses are usually excluded from insurance coverage. Nevertheless, ESMA maintained its view that mechanical failures shall also adequately be covered since they may represent an important source of losses for the AIFM.

ESMA did not consider appropriate to introduce any grandfathering provisions on the PII requirements also taking into account that there was no empowerment in that connection within the AIFMD.

As for the risks that managers of non-listed real estate funds are liable for there is no need of any specific guidance since the risks for which the AIFM is liable for are applicable to all kind of AIFM.

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?

43. Some asset managers considered the rule feasible, but very far going. Since it is not necessary to require a double layer of safeguards at the level of the AIFM and at the level of the external valuer, they asked making due allowance for adequate capital backing or insurance coverage provided by the external valuer.

44. The majority of asset managers and some representatives of insurers did not consider feasible and/or practicable for an AIFM to obtain PII in relation to the valuation performed by an external valuer since the AIFM should be liable for the negligent selection of an external valuer and be able to purchase PII to cover breach of its professional duties when appointing the external valuer, but not to cover the negligent acts by a third party; one respondent also added that if insurance were required to cover improper valuation of assets, the problem of 'double coverage' would arise.

    ESMA's response: ESMA did not consider appropriate to exclude from the risks to be covered the valuation performed by an appointed external valuer since according to Article 19(10) of the AIFMD, the liability of the AIFM shall not be affected by the fact that it has appointed an external valuer.

Box 7 – Qualitative Requirements (based on Annex X Directive Part 3 2006/48/EC)

45. A minority of asset managers supported the notion of establishing a historical loss database at the AIFM level.

46. Some respondents asked to clarify that the reference to a 'historical loss database' requires recording only of material losses arising from significant operational failures and not of any losses experienced (for instance, even those arising as a result of normal investment activity).

47. While recognising the benefits of collecting and retaining loss data as means of understanding potential liabilities arising from professional negligence, some institutional investors' representatives made a general comment arguing that 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. As for the requirement according to which risk management activities should be performed independently, the same institutional investors' representatives recommended that any rules should allow and specifically support a 'three lines of defence' model (based on a first line management function, a second line risk function and a third line internal audit function) which is a typical model of risk management.

48. The majority of asset managers advocated that the 'Advanced Measurement Approach' was deleted from the proposal. Some of them mentioned that no AIFM would have sufficient historic loss data to make use of this methodology. Others pointed out that AIFMs presented a completely different type of risk as compared to credit institutions and investment firms and it would not

make sense to apply the 'Advanced Measurement Approach' policy to meet the risks posed by AIFM. Private equity managers also mentioned that (i) the approach related to an operational risk requirement and there was no mention to such a requirement in the AIFMD and (ii) the 'Advanced Measurement Approach' concept had so far only been applied to credit institutions and to investment firms which deal on own account or underwrite.

49. Some of the asset managers not supporting the proposal on the 'Advanced Measurement Approach' suggested that the reference to operational risk (if kept) should be limited to an obligation to implement risk management facilities reflecting the size and internal organisation of the AIFM, and the nature, scale and complexity of its activities.

50. Some respondents pointed out that the AIFMD did not provide for any obligation for AIFM to measure, manage or mitigate operational risk. In order to ensure that Level 2 provisions do not go beyond the AIFMD, some of such respondents recommended a clarification that the requirement to 'maintain a separate operational risk management function' refers exclusively to the provisions set out in Box 30 and does not require establishing a separate function for managing risks relating to operational liability.

ESMA's response: ESMA acknowledged the concerns expressed by the industry on the difficulties to set out a 'historical loss database' for the AIFM. However, ESMA maintained its approach since it considered important to mitigate operational failures and liabilities through the implementation of appropriate internal control mechanisms for operational risks, including the building up of an internal loss database as basis for the assessment of the operational risk profile of the AIFM.

51. As for the absence of any reference to the operational risks requirements under the AIFMD, ESMA recalls that Article 24(2)(c) of the AIFMD explicitly refers to operational risk as one of the risks to be managed by the risk management systems employed by the AIFM. ESMA did not consider appropriate to refer to the proportionality principle in relation to operational risks.

Box 8 – Quantitative Requirements

52. The very large majority of respondents preferred option 1 under Box 8. A small minority of respondents either preferred option 2 or recommended that both option 1 and option 2 should be made available to an AIFM.

53. Some of the asset managers preferring option 1 mentioned that there was no logical link between the liability risk and the income of an AIFM foreseen under option 2. The same asset managers explained that option 2 was more complicated and left wide room for diverging interpretations by the different competent authorities, in particular in relation to the 'relevant income', which was also difficult and cumbersome to determine in practice. A respondent mentioned that it should be guaranteed that the liability risk of 0,01% remained fixed and should not be increased over time. Another respondent mentioned that its preference for option 1 was justified by the fact that the risks covered by the CRD are not comparable with the risks which may be incurred in the management of non-tradable closed-ended funds.

54. Among the respondents preferring option 1, certain critics were made to the rules set out by such option. Private equity representatives mentioned that no objective rationale was provided for the level of additional own funds based on assets under management and that one effect of the own funds requirements will be to decrease the amount of money which is available to individual executives for investment into AIFs. Some asset managers' representatives asked for significantly lowering the quantitative requirements for both options; indeed, in both cases, the requirements seemed to them very high compared to historical loss data.

55. Private equity representatives proposed that AIFMs have up to 6 months to finalise the revised figures, due to the gap between the end of the financial year and the date on which the updated fund valuation is available/reported.

56. Several asset managers' representatives agreed with the proposal that national competent authorities shall have the power to lower the additional own funds requirements, whereas other asset managers' representatives were of the opinion that this could lead to regulatory arbitrage and market distortions between member states and suggested that the power should be exercised by ESMA.

ESMA's response: Given the broad support for option 1, ESMA decided to choose such option and not to include the income of the AIFM as a proxy for liability risk.

57. ESMA believed that the quantitative requirement set out in option 1 was appropriate and that there was no need for lowering it, also considering the flexibility given by the newly introduced possibility of combining the additional own funds and the PII.

58. ESMA did not consider necessary to introduce a timeframe for the yearly recalculation and adjustment of the additional own funds.

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

59. The vast majority of respondents considered that the term 'relevant income' should not include performance fees. Some of the respondents explained that there is no direct link between an increase of such fees and an increase of risk and that the level of fees received was an appropriate approximation to determine the risk of professional negligence posed by an AIFM; furthermore, for some asset managers, this would entail a change of the own funds of the AIFM from year to year, notwithstanding the fact that risks remained constant. Some institutional investors' representatives added that for self-managed AIFs the only income received will be from investments as the AIFM would not receive income in relation to collective portfolio management activities or from any other source. A stakeholder also mentioned that the inclusion of relevant income solution would give misleading impression of volatility in relevant income, as performance fees are not typically paid out on an annual basis but are carried over.

60. A very minor set of respondents considered feasible and practicable that the term 'relevant income' included performance fees.

ESMA's response: Given that ESMA choose option 1 under Box 8, the reference to the 'relevant income' was no longer relevant since deleted from the provisions of Box 8.

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')?

61. The vast majority of respondents considered that the term 'relevant income' should not include the sums of commissions and fees payable in relation to collective portfolio management activities and several respondents reiterated that the use of income should not be made for approximating professional liability risk.

ESMA's response: Given that ESMA choose option 1 under Box 8, the reference to the 'relevant income' was no longer relevant since deleted from the provisions of Box 8.

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.

62. Few respondents provided some useful empirical evidence predominantly showing that option 2 would result in a significantly higher requirement and thus helping ESMA in reaching its final decision to retain option 1.

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?

63. The majority of respondents considered that the 'Advanced Measurement Approach' should not be used. Some of them mentioned that the processes used by credit institutions have nothing in common with the activities of an AIFM and only large AIFM allied with banks would be able to provide the figures required. Other respondents did not see any need for allowing for the 'Advanced Measurement Approach' as an optional framework on the basis that within the AIFMD there was no specific obligation placed on an AIFM to manage operational risk.

64. Private equity representatives mentioned that it was unclear whether AIFMs should record data from 22 July 2013 or whether the requirement to hold such data would apply retrospectively.

ESMA's response: As explained above, ESMA decided to maintain its approach since it considered important to mitigate operational failures and liabilities through the implementation of appropriate internal control mechanisms for operational risks, including the building up of an internal loss database as basis for the assessment of the operational risk profile of the AIFM.

ESMA based its advice on the assumption that the relevant AIFMD rules should start to be applied as of 22 July 2013.

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?

65. Some asset managers' representatives were of the opinion that the minimum historical observation period of five years should be reduced, for example to three years: they considered that a five-year period would prevent AIFM with a shorter track record from applying for reduction of capital requirements.

66. Other asset managers considered that the five-year period was appropriate and should not be extended as it would be a sufficiently long period of time for an AIFM to demonstrate that it is capable of performing its duties correctly.

67. A respondent suggested that a '3 years or more' period should be introduced with the possibility for AIFMs which have been in existence for less than 3 years to consider data which cover the entirety of their existence.

68. Some stakeholders suggested that, in line with article 9(6) of the AIFMD, a reduction of 50% of the additional funds should be possible if the AIFM benefits from a guarantee of the same amount given by a credit institution or an insurance undertaking.

    ESMA's response: In light of the comments received from stakeholders, ESMA considered appropriate to shorten the five-year period to a three-year period, in order to allow AIFM with a track record shorter than five years, but reasonably acceptable to adequately observe the historical loss data of the AIFM, to apply for lowering the percentage of additional own funds. ESMA came to this conclusion also considering that the lower percentage of additional own funds is not granted automatically, but is subject to the approval of the competent authority of the home Member State of the AIFM.

    ESMA did not include the possibility to reduce of 50% the additional funds if the AIFM benefited from a guarantee of the same amount given by a credit institution or an insurance undertaking since it considered that the concerns related to the difficulties to comply with the additional own funds requirements were already sufficiently addressed by the possibility to combine the additional own funds and the PII according to the rules set out under the new Box 9 of the advice.

Box 9 – Professional Indemnity Insurance

69. Several asset managers' representatives considered that the reference to 'relevant persons' in paragraph 1(b) of Box 9 was excessive, given the broad definition of 'relevant persons'.

70. The majority of respondents asked to amend paragraph 1(c) of Box 9 taking into account that in practice insurance policies do not cover all the risks mentioned in Box 6, they usually set out exclusions and limits and often several insurances are concluded each covering only a portion of the risks. Insurers' representatives confirmed that each insurance policy contains a set of limits of

indemnity that minimises to what extent cover can be offered to professional indemnity risks and also provided examples of areas that are not likely to be covered by PII.

71. Some respondents mentioned that the wording of paragraph 1(d) of Box 9 was unclear.

72. Some asset managers' representatives suggested that the first sentence under paragraph 1(e) of Box 9 should stop after the words 'ongoing supervision' since for regulated insurance companies it should not be the task of the AIFM to assess the ability of the insurance company to pay claims and there should be a presumption of solvability.

73. Several respondents objected to the different treatment which 'affiliated' insurance companies are subject to according to paragraph 1(f) of Box 9 arguing that to the extent these entities are subject to the same prudential rules which 'independent' insurance companies are subject to, there should be no different treatment.

74. Some asset managers' representatives asked for a harmonisation of the frequency of the review which shall be conducted once a year and requested the deletion of the words 'at least' from paragraph 4 of Box 9; in addition, they argued that the review should occur in the event of any 'material' change and not in the event of any change (paragraph 4 of Box 9). Other asset managers' representatives suggested a list of changes which the review should be restricted to.

75. Private equity representatives supported an annual review by the AIFM since easier to enforce.

ESMA's response: As explained above, the reference to the 'relevant persons' has been replaced with a reference to the AIFM's directors, officers or staff or third parties for whom the AIFM has vicarious liability.

76. Considering the comments received from respondents, ESMA saw merit in amending paragraph 1(c) of Box 9 in order not to impede the standard exclusions and limits set out under insurance policies and also clearly recognised that several insurance policies may be concluded each covering only a portion of the risks, provided that overall all the relevant liability risks are covered and the required minimum coverage are ensured.

77. Further to the respondents' request for clarification, ESMA considered appropriate to modify the content of paragraph 1(d) of Box 9 to clarify that the own funds which shall covered any excess under the insurance policy are in addition to the own funds to be provided according to Articles 9(3) and 9(7)(a) of the AIFMD.

78. ESMA saw merit in providing for an assumption of solvability for EU regulated insurance undertaking, but decided to require that in case of third country insurance undertakings, the AIFM would have to demonstrate to the competent authority that the insurance undertaking has sufficient financial strength with regard to the claims paying ability.

79. ESMA recognised that there were no reasons for imposing a different treatment to 'affiliated' insurance companies since these entities are indeed subject to the same prudential rules which 'independent' insurance companies are subject to.

80. Finally, as for the frequency of the review, notwithstanding the comments received from some of the respondents, ESMA decided not to make any change to the provisions of the advice since

these provisions require an appropriate mechanism according to which the review is in principle annual, but may be more frequent in case of any change which affects the compliance of the policy with the requirements. The reference to the 'materiality' of the changes was considered not necessary to the extent that according to the relevant provisions the review is triggered not by any change, but only by those which affect the compliance of the policy with the requirements.

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.

81. The very large majority of respondents were of the opinion that the number of investors should not have any influence on the amount to be covered by the insurance and that one loss should lead to one event/claim in the insurance policy independently of the number of investors. A respondent mentioned that the existing minimum amounts for single claims were too high for non-tradable closed-ended funds, whereas the insurance amount for total claims per year was appropriate.

ESMA's response: In light of the comments received from respondents who clearly rejected the option of modifying the minimum coverage amounts to take into consideration the number of investors, ESMA decided not to introduce any amendment to the minimum coverage amounts.

IV.I. Possible Implementing Measures on General Principles

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

82. Some asset managers' representatives agreed with the proposal in paragraph 1 of Box 10, but claimed for the adoption of a horizontal legislation introducing a level playing field since for the time being only UCITS management companies and AIFM are subject to such kind of obligations.

83. Some real estate and private equity representatives mentioned that, for real estate investments, transactions are negotiated bilateral deals and, therefore, asked for introducing the proportionality principle in Box 10.

84. Private equity representatives also mentioned that it was unclear what undue costs referred to in a private equity/venture capital framework where no trades took place: they therefore asked to limit the scope of paragraph 2 to those AIFM 'managing AIFs which are trading with securities'.

ESMA's response: ESMA decided not to take into account the claims for the application of the proportionality principle as regards the requirements under Box 10 since these are behavioural and not organisational requirements and should therefore apply whichever the size of the AIFM and the nature of its business are.

85. ESMA did not consider appropriate to carve out any specific kind of funds from the relevant requirements since undue costs might be charged whichever the assets into which the AIF invests are.

Box 11 – Due Diligence requirements

86. On paragraph 1 of Box 11, private equity and venture capital representatives objected that for private equity and venture capital managers an investment decision is a very subjective matter, there is no right level of due diligence to be applied and a 'high' level of due diligence should not be required in all circumstances; they proposed that the level of due diligence undertaken be consistent with the risk management policy of the AIF and also asked for deleting the reference to acting in the best interest of the AIF's investors.

87. The same private equity and venture capital representatives mentioned that it was unclear what the AIFM's qualifications to be met according to paragraph 2 of Box 11 referred to and suggested deleting paragraph 2.

88. Institutional investors' representatives requested to clarify in the text of Box 11 that the requirements in its paragraph 4 apply only where appropriate, i.e. for real estate and private equity vehicles and asked to amend the wording of paragraph 4(c) to include that this should be completed on a 'best endeavours' basis.

89. A large number of respondents suggested that paragraphs 4 and 5 of Box 11 should require that only evidence regarding significant investments, not investment opportunities should be kept.

90. One respondent mentioned that Box 11 established additional, disproportionate due diligence obligations.

    ESMA's response: ESMA did not consider appropriate to carve out any specific kind of funds from the relevant due diligence requirements since those should be complied with by any kind of funds to the extent they may be applicable to their activities.

91. ESMA considered that paragraph 2 of Box 11 provided sufficient details on the AIFM's qualifications to be met and did not agree on the deletion of these provisions.

92. ESMA considered there was no need to further clarify that paragraph 4 of Box 11 was relevant only for real estate and private equity funds, since the provisions of paragraph 4 of Box 11 already explicitly stated that the relevant requirement were relevant only where applicable to the type of the assets which the fund is invested into.

93. ESMA decided to keep the reference to the requirement to keep evidence of investment opportunities to the extent that the requirement is limited to the significant ones and not to any kind of investment opportunity examined or considered.

94. ESMA believed that the due diligence requirements of Box 11 were not disproportionate since in line with the UCITS approach with due adaptations for AIF investing in specific type of assets.

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?

95. A large amount of respondents did not agree with the use of the term 'business plan' and proposed several alternative terms (e.g. 'investment proposal(s)', 'investment policy(ies)', 'risk appetite statements', 'investment plan').

96. The minority of respondents agreed that the term 'business plan' could be used.

ESMA's response: Notwithstanding the fact that the term 'business plan' was not favoured by most of respondents, ESMA preferred to keep the reference to such term 'business plan' since the consultation did not evidence any largely agreed alternative term to be used.

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

97. In order to reflect the specificities of the private equity/venture capital and real estate sectors, several representatives of such sectors suggested amending Box 12 to include a statement that where an investor has been provided with a subscription agreement or deed of adherence which states the amount of the customer's subscription in a fund, the subscription requirement should be satisfied.

98. Some respondents mentioned that where the subscription or redemption orders are processed by a third party (e.g. a third party distributor) and not by the AIFM, it should rather be the respective third party obligation to comply with these reporting requirements.

ESMA's response: ESMA saw merit in amending the provisions of Box 12 to cover the specificities of the subscription methods in private equity, venture capital and real estate funds. ESMA decided to also amend the box to cover the cases where the subscription or redemption orders are processed by a third party and provided that in such cases the reporting obligations would not apply to the AIFM, to the extent that the third party is obliged to provide the investor with a confirmation of the order including the essential information and the third party complied with such obligation.

Box 13 – Selection and appointment of counterparties and prime brokers

99. Several asset managers' representatives proposed to delete the reference to counterparties in paragraph 1 of Box 13 since it was not mandated by article 14(3) of the AIFMD and thus it was outside of the scope of the Level 1 directive. Some depositaries' representatives suggested enlarging the scope of eligible counterparties under paragraph 3 in order to include clearing brokers for exchange traded derivatives as well as counterparties for time deposit and for securities lending transactions.

100. Private equity representatives asked clarifying that the counterparty referred to in Box 13 was a financial sector transactional counterparty providing services to the AIF.

101. Some depositaries' representatives suggested that the text of Box 13 should oblige the AIFM which appoints counterparties and prime brokers with similar duties as described under Box 75 to ensure that the depository receives from counterparties and prime brokers the information it may require in order to discharge its duties and obligations of safekeeping and oversight. In addition, they suggested the following further changes relating to the appointment of prime brokers:

(i) either it should be clarified that prime brokers are subject to similar requirements as for any third party where cash accounts are opened (i.e. entities referred to in article 18(1)(a) to (c) of the Directive 2006/73/EC or another entity of the same nature in the relevant market where the prime broker is located) or in the case of appointment of a prime broker Box 76 shall not apply; and

(ii) in case of re-use of the AIF's assets by a prime broker, appropriate disclosure of such re-use and inherent risks shall be made in the prospectus, in order to be consistent with the depository's obligations under paragraph 8 of Box 74.

102. Real estate representatives pointed out that the use of counterparties and prime brokers is relatively uncommon in non-listed real estate funds, except in the case of interest rate hedging, where the bank providing the loan requires the hedge to take place with a specific broker acting as counterparty, thus reducing the capacity of the fund to select the counterparties or prime broker.

103. Some respondents suggested modifying paragraph 1 of Box 13 in order:

- to limit the range of services to be considered when selecting and appointing a counterparty to the limited services the AIFM would like to mandate the counterparty for and not the full range of services provided by the counterparty, and

- to consider sufficient that counterparties and prime brokers are subject to authorisation and supervision in their jurisdiction (i.e. it shall not be required an ongoing supervision in any jurisdiction in which the counterparty is active).

104. Some asset managers representatives suggested modifying paragraph 3 of Box 13 to 'counterparty of an AIFM or AIF' as in practice the relevant contracts are concluded in the name of the AIF or the AIFM.

ESMA's response: As for the claimed absence of adequate coverage of the provisions of Box 13 in the Level 1 Directive, ESMA considered that Article 12(1)(a) of the AIFMD, even if not mentioning counterparties and prime brokers, provided an adequate legal basis for the provisions of Box 13.

ESMA was of the opinion that no additional clarifications were required as for the definition of counterparty provided in Box 13.

ESMA recognised the merit of the comments made by some depositaries' representatives in relation to the information to be received by the depositaries from counterparties and prime brokers and addressed the relevant concerns in a new Box 82.

ESMA did not limit the conditions for the selection and appointment of counterparties since it considered that an AIFM should globally look at a counterparty to be appointed considering the full range and quality of its services.

Finally, ESMA agreed to modify paragraph 3 of Box 13 to 'counterparty of an AIFM or AIF'.

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

105. Private equity representatives asked to delete the reference to the investors of the AIF in paragraph 1 of Box 14 since the Level 1 directive recognised that the AIFM's duties are to the AIF, not to the AIF's investors.

106. Several respondents requested to clarify directly in the text of Box 14 instead of under the relevant explanatory text that paragraph 1 of Box 14 shall apply to all AIFs while paragraphs 2 to 5 of Box 14 only apply to those types of AIFs which acquire or sell financial instruments or other assets for which best execution is relevant. Some asset managers further asked for the deletion of the words 'or other assets that are' after 'financial instruments' since further requirements are tailored to transactions in financial instruments, but not to other asset types like real estate, private equity, ships, etc.

107. Private equity and real estate representatives asked for modifying paragraph 6 of Box 14 to cover the fact that for investments in real estate or unlisted companies there is no execution venue at all.

ESMA's response: ESMA did not agree on the deletion of the reference to the interest of the AIF's investors from paragraph 1 of Box 14 since such reference reflects the provisions of Article 12(1)(b) of the AIFMD.

ESMA did not see any need to add in the content of Box 14 any reference to the fact that paragraphs 2 to 5 of Box 14 only apply to those types of AIFs which acquire or sell financial instruments or other assets for which best execution is relevant since such clarification is clearly provided under the relevant explanatory text and paragraph 6 clearly states that the requirements under paragraphs 2 to 5 of Box 14 do not apply whenever there is no choice of different execution venues (which shall obviously include the cases where there is no execution venue at all). Furthermore, ESMA decided not to delete the reference to the 'other assets' in paragraph 2 of Box 14 since it is intended to cover trading on assets like commodities for which best execution is relevant.

Box 15 – Placing orders to deal on behalf of AIFs with other entities for execution

108. Several respondents requested to clarify directly in the text of Box 15 instead of under the relevant explanatory text that paragraph 1 of Box 15 shall apply to all AIFs while paragraphs 2 to 5 of Box 15 only apply to those types of AIFs which acquire or sell financial instruments or other assets for which best execution is relevant. Some asset managers further asked for the deletion of the words 'or other assets that are' after 'financial instruments' since further requirements are

tailored to transactions in financial instruments, but not to other asset types like real estate, private equity, ships, etc.

109. Private equity and real estate representatives asked for modifying paragraph 5 of Box 15 to cover the fact that for investments in real estate or unlisted companies there is no execution venue at all.

ESMA's response: The same response provided above under Box 14 applies here mutatis mutandis.

Box 16 – Handling of orders – general principles

110. Some respondents requested to insert in the text of Box 16 the clarification included in the relevant explanatory text according to which Box 16 does not apply where the investment in assets is made after extensive negotiations on the terms of the agreement.

ESMA's response: ESMA did not consider appropriate to insert the provisions of the explanatory text in the content of Box 16 since these are an explanation for the advice given.

Box 17 – Aggregation and allocation of trading order

111. Some respondents requested to insert in the text of Box 17 the clarification included in the relevant explanatory text according to which Box 17 does not apply where the investment in assets is made after extensive negotiations on the terms of the agreement.

ESMA's response: The same response provided above under Box 16 applies here mutatis mutandis.

Box 18 – Inducements

112. Real estate representatives argued that a property company's income did not derive from its shareholders, in the way that the income of an external AIFM derived from the AIF it managed; thus, it would be very difficult to apply the proposed rules on inducements to property companies.

113. Some asset managers and institutional investors were of the view that the rules of Box 18 should apply to direct marketing by the AIFM, but they disagreed that they should apply to 'indirect marketing', as mentioned in the relevant explanatory text. The same asset managers considered that distribution through intermediaries should not constitute part of the fund management services as specified in Annex I to the AIFMD since external intermediaries who are not tied agents act in their own capacity and under their own responsibility. Furthermore, they mentioned that fees and commissions received by intermediaries as remuneration for their distribution services are already regulated by MiFID and therefore there is no need to require justification of the same payments in relation to collective portfolio management.

114. Other asset managers similarly asked not applying inducement rules on third party marketing and proposed that the requirement to 'enhance the service' in paragraph 1(b)(ii) was amended as regards marketing services by amending the wording to 'must not impair the quality of the relevant service'. Private equity representatives requested to delete the reference to the enhancement of the quality of the service in paragraph 1(b)(ii) since if an AIFM received a payment from a third party, it would be difficult to see how that payment could enhance the quality of the service; in that case, the main question would be whether the payment gave rise to a conflict with obligations to the AIF or impaired compliance with the duty to act in the AIF's best interests. Alternatively, the same private equity representatives and some institutional investors asked to include an adapted version of recital 39 of the MiFID implementing measures.

115. Furthermore, some asset managers considered disproportionate to restrict the receipt/payment of inducements since the AIFMD is aimed at AIFs marketed to professional investors. Therefore, it should be sufficient to rely upon the disclosure requirement under paragraph 1(b)(i) of Box 18; member states could impose stricter requirements for marketing to retail investors should they allow such marketing.

116. Private equity representatives considered essential that the reference to the 'essential terms of the arrangements' under paragraph 2 of Box 18 should be interpreted so that a generic disclosure covering the types of fee which may be received or paid should be sufficient.

ESMA's response: ESMA decided not to introduce any change to the provisions of Box 18 to the extent considering appropriate to apply MiFID inducement rules to AIMF providing the service of collective portfolio management bearing in mind that those AIFM providing the service of individual portfolio management are already subject to such rules. This is obviously without prejudice of any future development of the MiFID rules; in such case, the rules set out in Box 18 should be aligned with the relevant developments.

Box 19 – Fair treatment by an AIFM

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

117. Several asset managers preferred option 1 in Box 19 since it provided more legal certainty leaving less room for divergent interpretations.

118. Other asset managers preferred option 2 in Box 19. Some of them preferred such option as long as such preferential terms may be made known to all other investors in an AIF. Others mentioned that preferential treatment should be permitted provided that it has been disclosed to other investors prior to investment in the funds.

119. A relevant number of respondents (including asset managers and institutional investors) considered that neither option 1 nor option 2 in Box 19 were preferable. They provided the following comments to support their opinion: some of them mentioned that the Level 1 text was sufficient and no further detail was required at Level 2; others were of the opinion that the proposal went beyond Level 1 (which only provided that preferential treatment is prohibited unless it is disclosed to the other investors); private equity representatives highlighted a series of

potential issues related to the two options (in particular, the reference to an 'overall material disadvantage to other investors' left too much legal uncertainty); real estate representatives mentioned that the disclosure to investors could be made in general terms in the AIF's prospectus or offering document provided that the details of any such preferential treatment are disclosed to those investors affected thereby prior to investment.

ESMA's response: The European Commission requested to provide advice on the criteria to be used by the relevant competent authorities to assess whether AIFM comply with the obligations under Article 12(1) of the AIFMD, including treating all investors fairly.

Therefore, ESMA advice provided guidance on the definition of fair treatment. ESMA was of the view that the first paragraph of Article 12(1)(f) of the AIFMD provided the general principle of fair treatment of investors whereas the second paragraph provided an exception to the principle allowing a preferential treatment to the extent that it is disclosed to investors. However, such preferential treatment should be read in conjunction with the general principle; therefore, in principle any preferential treatment should not have a material disadvantage to other investors.

ESMA is aware of the fact that a principle of fair treatment is already contained in most, if not all, of the national regulatory frameworks under which competent authorities currently operate and decided that it was not appropriate to provide a maximum harmonising definition of fair treatment, in order to allow competent authorities to duly take into account the facts of a particular circumstance or case.

ESMA therefore indicated that fair treatment may include that no investor may obtain a preferential treatment that has a material overall disadvantage to other investors, but did not provide a definition which comprehensively defines fairness.

IV.III. Possible Implementing Measures on Conflicts of Interest

General comments

120. Institutional investors generally supported the approach taken as regards conflicts of interest, in particular because of the large consistency with the UCITS and MiFID Level 2 rules.

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

121. Some asset managers were of the view that the reference to the 'relevant person' (given the definition of such terms) would imply that the AIFM would have to take into consideration all type of conflicts of interest along the entire delegation chain and even internally to relevant persons.

122. Some respondents mentioned that the term 'client' was not defined and suggested replacing it with 'any other contractual party'.

123. Hedge funds managers' representatives asked for limiting the requirement to identify conflicts to those which may be potentially be detrimental to investors or the relevant AIF.

124. Private equity representatives requested to clarify that paragraph 1(a) of Box 20 only covers compensation which gives rise to a conflict and to delete the words 'or its investors' to the extent the AIFM's duties are to the AIF and not to its investors. The same representatives proposed an amendment to the provisions of paragraphs 1(a),(b) and (c) to allow the disclosure of a conflict to the investors or the discussion with the investor advisory board. In addition, they asked the deletion of paragraph 1(d) of Box 20 since management activities may be carried out for different AIFs to the extent they do not give rise to a conflict.

ESMA's response: ESMA considered appropriate not to modify the text of Box 20 since it largely mirrored the relevant UCITS Level 2 provisions, thus achieving the appropriate level of horizontal consistency requested by the European Commission. In particular, ESMA did not take into account the requests made by the respondents of the consultation which were against the Level 1 text constraints (i.e. the request of limiting the requirement to identify conflicts to those which may be potentially be detrimental to investors or the relevant AIF and the claim that the AIFM's duties are to the AIF and not to its investors).

Box 21 – Conflicts of interest policy

125. Private equity representatives were of the opinion that it was important to keep the liberty of investors who wished that the AIFM was allowed to go ahead with a certain action despite the disclosure of a conflict of interest and proposed to amend paragraph 2(b) of Box 21 accordingly.

126. Several asset managers and institutional investors' representatives asked to ensure that an AIFM was not required to take on full liability for conflict management policies of third parties and to align the AIFMD provisions with those of MiFID and UCITS directive which provided that conflict identification obligations should apply where functions are delegated but not imply that an AIFM is fully liable for the acts of its delegate.

ESMA's response: ESMA considered appropriate not to modify the text of Box 21 since it largely mirrored the relevant UCITS Level 2 provisions. ESMA was of the opinion that the reference to the activities carried out by third parties was not in contrast with the provisions of MiFID and UCITS directive, but only provided a clarification on the entities which shall be covered by the reference to the activities carried out by or on behalf of AIFM, a similar reference being also included in the provisions of MiFID and UCITS directive.

Box 22 – Independence in conflicts management

127. Hedge funds managers' representatives supported the consistency in the relevant language with the equivalent provisions in MiFID and UCITS directive.

128. Some asset managers did not see the need for a separate supervision of the relevant person, as provided under paragraph 2(b) in Box 22.

129. Private equity representatives proposed the deletion of paragraph 2(c) of Box 22 as they believed it was redundant with the provisions of paragraphs 2(d) and 2(e).

ESMA's response: ESMA considered that no adequate evidence was provided by respondents for modifying the text of Box 22 which largely mirrored the relevant UCITS Level 2 provisions, thus achieving the appropriate level of horizontal consistency requested by the European Commission.

Box 23 – Record keeping of activities giving rise to detrimental conflicts of interest and way of disclosure of conflicts of interest

130. Some asset managers reiterated the comment made under Box 20 (i.e. alignment with the provisions of MiFID and the UCITS directive) and suggested the deletion of the reference to article 14(1) of the AIFMD in paragraph 2(a) of Box 23 since otherwise such obligation would cover any conflict of interest instead of those that are potentially detrimental to clients only.

131. Some of the aforementioned asset managers also asked modifying the requirements under paragraph 3 in Box 23 since in case of indirect distribution or of trading of parts of the AIF on a secondary market, the AIFM has no direct contact with the investors.

132. Several respondents proposed deleting paragraphs 3(a) and (b) since all professional investors have access to the internet and there should be no need to obtain investor consent to this method of disclosure.

ESMA's response: For the reasons mentioned above under Box 20, ESMA did not take into account the request of limiting the requirement to identify conflicts to those which may potentially be detrimental to investors or the relevant AIF.

ESMA considered that the Level 1 provisions did not make any distinction between direct and indirect distribution and, therefore, decided not to provide any limitation of the relevant requirements in case of indirect distribution.

ESMA agreed with the comment made by some of the respondents on the general availability of an internet access for professional investors and decided to delete the requirement imposing to the AIFM to ensure the existence of an evidence of such access, but saw merit in keeping the requirement that the investor shall consent to the provision of information via a website.

Box 24 – Strategies for the exercise of voting rights

133. Several asset managers welcomed the alignment of the provisions on the exercise of voting rights to those under the UCITS framework and some of them specifically supported the fact that the disclosure method under paragraph 3 of Box 24 was less onerous than under the UCITS directive.

134. Other respondents were of the opinion that the proposal under Box 24 was disproportionate and overly detailed and asked for the introduction of the proportionality principle for the application of the relevant provisions.

ESMA's response: ESMA decided not to take into account the claims for the application of the proportionality principle as regards the requirements under Box 24 since these are behavioural and not organisational requirements and should therefore apply whichever the size of the AIFM and the nature of its business are.

IV.II. Possible Implementing Measures on risk management

Box 25: Permanent risk management function

135. ESMA received several comments on Box 25 and the requirements concerning permanent risk management function.

136. It was asked that the reference to 'effective' risk management be linked to an element of proportionality in paragraph 1(a).

137. Other respondent were of the view that the requirements in Box 25 should take into account the nature, scale and complexity of the business and the AIFs managed by the AIFM and that paragraph 1(a) should include an element of materiality.

ESMA's response: ESMA did not share the opinion of the respondents to the consultation that called either for the introduction of the principle of proportionality in paragraph 1(a) or in the entire Box 25. Indeed, provisions in Box 25 are general provisions that should be complied with by all AIFMs regardless the size of the structures or the type of AIFs managed.

Box 26: Risk management policy

138. Respondents were generally in agreement with ESMA's proposal but made some specific drafting comments which were mostly concentrated on paragraph 1 of Box 26:

- According to some respondents, 'reasonably' should be added to the paragraph 1 in order to be in line with paragraph 1(a) of Box 25.
- Other contributors were of the view that the paragraph should read as follow: '*AIFM shall establish implement…all the* <u>*material*</u> *relevant risk…might be exposed to*'
- The following drafting for paragraph 1 was also proposed '*AIFM shall establish, implement and maintain an adequate and documented risk management policy which identifies ~~all the~~ relevant risks to which the AIF they manage are ~~or might be~~ exposed to.*'

139. Some stakeholders were of the view that a key element was that any disclosure to non-investors should be limited to regulators so that an AIFM's know-how would not be required to be made available in uncontrolled way.

140. In relation to sub-paragraph 3(e), several respondents asked the focus be on ensuring that the safeguards are applied, rather than creating a requirement for more paper documenting compliance.

141. It was pointed out that most of the provisions were more relevant for AIFs that hold financial instruments rather physical property. In particular, it was stressed that in non-listed real estate funds, investment decision are made through an investment committee or similar committee or advisory boards that consider the risk involved prior to investment.

142. ESMA was also asked to use the notion of 'independent' risk management function rather than 'separate' risk management function in order to be aligned with the UCITS IV Directive.

ESMA's response: ESMA carefully analysed the comments received and did not feel appropriate to take on board the drafting suggestions made for paragraph 1(a) of Box 26. As regards the use of 'independent' risk management function instead 'separate' risk management function, ESMA believes preferable to stick to the Level 1 Directive that refers to separate function.

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

143. According to some respondents it was unclear how any assessment, monitoring and review should be documented, especially if no material change statement need to be made to an AIF's risk management policy.

144. For other stakeholders paragraph 2 should be aligned to Article 39(2) of the UCITS Directive and should read as follow: 'AIFM shall notify the competent authorities of their home Member State of any material changes to the risk management process'.

145. One contributor proposed that the notification of any material changes to the risk management policy from AIFMs to competent authorities should be requested by competent authorities themselves.

ESMA's response: ESMA was not in favour of amending the paragraph 2 of Box 27 as suggested by some respondents and this paragraph was in any event consistent with the UCITS requirement. According to ESMA, any material changes to the risk management system should be notified by AIFM and not requested by competent authorities that cannot be aware of such modifications.

Box 28: Measurement and management of risk

146. Respondents generally agreed with ESMA's proposal but some drafting suggestions to paragraphs 1(a), 3(a), 3(b), 3(c) and 3(e).

147. The amendments suggested to paragraph 1(a) were the following:

- The end of sentence '*including those sources of risk that the AIFM incurs on behalf of the AIF*' should be deleted in order to aligned with the UCITS IV Directive;
- The words '*might be*' should be deleted; and
- Paragraph 1(a) should read as follow '*… risks to which…might be <u>reasonably</u> exposed to…*'

148. The amendments suggested to paragraphs 3(a) were the following:

- The part of the paragraph which reads '*on the basis of sound and reliable data*' should be deleted in order to be aligned with the UCITS IV Directive.

149. The amendments proposed for paragraph 3(b) and 3(c) were:

- Both paragraphs should read '*conduct, where appropriate, periodic...'* to be more aligned with the UCITS IV Directive. According to some respondents this addition was required by the need to reflect differentiation of standards depending on the type of AIF, its investment strategy and portfolio of assets.

- Actions to be taken under paragraph 3 should be considered as 'possible' action.

150. On paragraph 3(e), the deletion of the reference to *anticipated* breaches was proposed.

151. Finally, some drafting suggestions were made to paragraph 2 to make clearer that actions under paragraph 3 shall be proportionate to the nature, scale and complexity of the AIF.

ESMA's response: ESMA deemed it appropriate to delete in paragraph 1(a) the end of sentence referring to 'including those sources of risk the AIFM incurs on behalf of the AIF' and changed the paragraph accordingly. ESMA also agreed to delete in paragraphs 3(a) and 3(b) the reference to '*on the basis of sound and reliable data*'.

Box 29: Risk limits

152. One respondent believed that the entire Box 29 should be deleted as it was unnecessarily prescriptive and goes beyond what is required today by the MiFID.

153. According to several stakeholders paragraph 2 of Box 29 should read as follow: 'The qualitative and quantitative risks limits for each AIF shall, at least, cover the following risks where relevant'.

154. The following drafting was also proposed for paragraph 2: 'The qualitative… cover the following risks relevant for the specific type of AIF and its investment strategy which may include, for example, the following'.

ESMA's response: ESMA disagreed with the suggestion to delete the Box 29 for the reason that the provisions were going beyond what is required today by the MiFID and did not modify the Box 29 in the final advice.

Box 30: Functional and hierarchical separation of the risk management function

155. As regards paragraph 1(a), some investment manager associations considered that the requirement that the risk management is not supervised by those responsible for the operating units was unlikely to be met by a large number of AIFMs, since both the risk management function and the portfolio management function may well have the same reporting lines. This comment was confirmed by a representative of the real estate industry that stressed that complete separation of operation and risk management would not be possible for non-listed real estate industry which requires that risks are managed at all levels of operation.

156. Concerning paragraph 1(e), several investment manager associations felt that this requirement would be very difficult to be met by small self-managed AIF and therefore asked for the

separation to be made up to the senior management level. According to one of them, it should be sufficient for this requirement to be fulfilled if there was a direct reporting line by the head of the risk management function to the governing body.

157. Concerning the additional safeguards referred in paragraph 3, one investment manager association strongly believed that they should not be documented in the risk management policy but rather in the general management process of conflicts of interest.

158. For one contributor, the private equity and venture capital industry would not be able to have a separate risk management function and the proposed safeguards proposed by ESMA in case of no hierarchical separation were not appropriate. According to this contributor the ESMA's proposal was not tailored for the private equity and venture capital sector and safeguards envisaged in paragraph 3 of Box 30 would result in additional costs to be borne by investors. Finally, this respondent believed that there should be a possibility for AIFM to disclose to investors of non-segregation of conflicting duties if it is disproportionate to the nature, scale or complexity of the AIFM.

159. Concerning paragraph 3(d), a couple of investment manager association asked ESMA to provide more clarity on what could be considered as 'an independent external party'.

160. On paragraph 3(e), an investment manager association was of the view that there should be a small AIFM carve-out, notwithstanding the proportionality qualifier.

ESMA's response: Despite the comments made by respondents, ESMA felt the approach taken appropriate and did not deem necessary to modify the advice. Indeed, according to paragraph 2 of Box 30, competent authorities shall review the functional and hierarchical separation of the functions of risk management in accordance with the principle of proportionality. Therefore, this provision allows the general framework set by ESMA to be adapted to the nature, scale and complexity of the AIFM.

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?

161. Respondents to the consultation generally believed that there was no need for additional safeguards.

ESMA's response: Based on the feedback received, ESMA does not recommend further safeguards so as to achieve the objective of an independent risk management function.

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

162. According to several respondents smaller funds, highly automated funds, exotic funds and private equity would have the most difficulty in demonstrating an independent risk management function.

163. It was stressed that non-real estate funds are organised in such a way that a process driven risk management approach is employed at all levels to achieve the goals of functionally and hierarchically separated risk management.

Possible Implementing Measures on liquidity management

Box 31: Liquidity management definition

164. According to some stakeholders gates should not be covered by the provisions regarding the application of 'special arrangements'. On the same point, it was proposed to delete the reference to 'gates' in paragraph 9 of the explanatory text under Box 31 because there was no defined term of what constitutes a gate.

165. Besides some respondents suggested the use of 'type of unit/share' instead of 'class of unit/share' to avoid any confusion since the term 'class' could have a special meaning in some jurisdictions.

ESMA's response: ESMA agreed with these comments and the reference to gates in the explanatory text under Box 31 has been deleted in the final advice and the wording of the definition modified to reflect the suggestion made by respondents.

Box 32: Liquidity management policies and procedures

166. For one asset manager representative, the references to 'underlying obligations' to 'counterparties, creditors and other parties' in paragraph 1 were to be too broad. This respondent further pointed out that the Directive itself did not contemplate the AIFM being obliged to have regard to the interests of such parties and, moreover, doing so may potentially place the AIFM in a position where the interests of those parties conflict with its obligations to act in the best interests of the AIF or its investors.

167. Some asset managers were of the view that paragraph 1 should include a reference to appropriateness and proportionality rather than the concept being reflected in the explanatory text in paragraph 12.

168. The same trade association was of the view that paragraph 3(b) should be removed because it should not be the responsibility of the AIFM to seek to 'protect' one category of investors in the AIF over another who may be perceived as more or less likely to exercise those redemption rights.

169. For some asset manager representatives, paragraph 3(c) should be deleted because it would impede asset managers from using certain highly-liquid underlying investments (such as overnight money market funds) where it would be impracticable for them to undertake the prescribed reviews.

170. It was also asked that the reference to ‘sufficient prominence’ in paragraph 3(e) be deleted and pointed out that this paragraph was not relevant in the context of closed-end funds.

171. For one respondent, paragraph 3(f) should be limited to ‘special arrangements’ rather than referring to ‘tools and arrangements’. As regards this paragraph, the same respondent was of the view the use of liquidity tools should also be allowed if they are not disclosed to investors but only under circumstances where it is the best interest of investors and subject to the competent authority approval.

172. According to several asset managers, the requirement in paragraph 3(h) to update the liquidity management and procedures for ‘any changes or new arrangements’ was overly burdensome and should be modified to foresee an update for ‘any material changes.’

173. According to one representative of the real-estate fund industry, non-listed real estate funds should not be required to maintain cash liquidity above the amounts needed to cover immediate costs, such as payroll and taxes. For non-listed real estate funds, it would be problematic for funds to comply with higher minimum cash liquidity.

ESMA’s response: ESMA does not share respondents’ views on paragraph 3(h) according to which the liquidity management and procedures should be updated only in the case of material change. However, ESMA agreed to delete the reference to ‘sufficient prominence’ in paragraph 3(e) as requested by some stakeholders. With regards paragraph 3(f), ESMA is of the view that it should not be limited to ‘special arrangements’ and that liquidity tools and arrangements should only be allowed if appropriate disclosures have been made to investors. However, ESMA felt it appropriate to soften paragraph 3(f) and to refer to tools and arrangements that ‘may’ be used instead of ‘will be used’.

Box 33: Liquidity management limits and stress tests

174. As regard paragraph 1, one respondent was of the view that the provisions should be softened and provide some balancing between the strict liquidity requirements and the ability of the AIFM to take views on positions in investments that assume a certain degree of stability with the asset base of the AIF.

175. On the same paragraph, several investment manager associations believed that the last sentence should refer to ‘what course of action if any’ in order to better reflect paragraph 26 of the explanatory text according to which AIFM may determine that no action is required.

176. As regards paragraph 2(c), it was suggested that market risks should not be included in the assessment of liquidity risks, otherwise no clear result could be obtained regarding the liquidity of the AIF.

177. One respondent asked ESMA to clarify that paragraph 2(e) dealing with redemption policy was not relevant for closed-ended funds.

178. Concerning paragraph 3, many respondents believed that it would not be appropriate to require AIFM to ‘act in the best interests of investors’ as regard the outcome of the stress tests.

ESMA's response: ESMA carefully analysed the comments received during the consultation and did not deem it appropriate to take them on board and therefore did not modify the advice.

Box 34: Alignment of investment strategy, liquidity profile and redemption policy

179. See question 22 below.

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

180. Several investment manager associations believed that gates and side pockets should be considered as normal liquidity management tools, provided that investors are aware of their potential use by the AIFM. Furthermore, according to them, the use of gates and side pockets should not be considered as the result of a failure of the AIFM's liquidity management process.

181. The representatives of non-listed real estate funds did not provide ESMA with specific comments on special arrangements with the justification that they were uncommon in non-listed real estate funds.

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?

182. The majority of respondents answered this question via their comments on the relevant boxes.

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

183. According to several respondents, paragraph a) should be deleted. These respondents felt that the investment strategy, liquidity profile and redemption policy should be considered to be aligned when investors have the ability to redeem their investment in accordance with the AIF's redemption policy and obligation.

ESMA's response: Based on the limited number of comments on this issue, ESMA decided to keep the advice unchanged.

IV.VI. Possible Implementing Measures on Investment in Securitisation Positions

General comments

184. Some respondents (representing both asset managers and banks and other financial market participants) asked for harmonising some differences between the regime envisaged by the consultation paper on securitisation positions and the one under the CRD framework since, in principle, the same retention and due diligence requirements should apply to all types of EU regulated investors and that a different approach should be adopted only if and to the extent necessary. In particular, these respondents were of the opinion that the term ‘tradable securities and other financial instruments based on repackaged loans’ should be aligned more closely to the requirements under the CRD since it currently lacked any reference to tranching and appeared to limit the relevant securitisation underlying to loans.

185. Other respondents (representing institutional investors) were of the opinion that the requirements relating to securitisation were broadly comparable with those set out under the CRD.

186. Private equity and venture capital representatives did not have any comment to the possible implementing measures on investment in securitisation positions as they considered the relevant rules not applicable for private equity and venture capital.

ESMA’s response: ESMA saw merit in the request to further align the advice with the relevant provisions of the CRD by replacing the references to ‘tradable securities and other financial instruments based on repackaged loans’ with references to the ‘credit risk of a securitisation position’ and modified the advice accordingly.

Box 35 – Requirements for retained interest

187. Some asset managers mentioned that the AIFM would in practice not be able to verify that the originator, sponsor or original lender retains a net economic interest of at least 5% and considered the requirements in Box 35 too burdensome and going beyond what is required under the CRD.

188. Some respondents mentioned that paragraphs 1 and 3 of Box 35 implied that it may be necessary to calculate or measure the retained interest at the date that the investment activity is undertaken and for the retained net economic interest to be maintained at a 5% level for the life of the transaction, whereas this was inconsistent with the CRD provisions as interpreted by CEBS. The same respondents added that if the originator did not retain as it indicated that it would, the AIFM or the UCITS should not be obliged to take corrective action and should instead be left to determine the appropriate course of action (if any), as presumably it would be naturally incentivised to do.

189. Some hedge funds managers’ representatives asked for deleting the words ‘and, if later, at the date of assumption’ under paragraph 1 of Box 35 since such requirement was unclear and not imposed by the CRD provisions.

ESMA's response: ESMA acknowledged the concerns expressed by some respondents on the difficulties for the AIFM or the UCITS to check retained economic interest, but remained of the view that the overall horizontal regulatory approach contained a certain element of indirect regulation and that the parties to the securitisation transaction are obliged to retain in order for an AIFM (or UCITS respectively) to be 'entitled' to make the investment. However, ESMA felt appropriate to clarify that the AIFM should consider a corrective action whenever the retained net economic interest becomes less than 5% after the assumption of the exposure, but only to the extent that the interest did not decrease as a consequence of the contractual waterfall of the transaction.

19. Furthermore, ESMA saw merit in the request to delete the words 'and, if later, at the date of assumption' under paragraph 1 of Box 35 and modified the text accordingly.

Box 36 – Requirements for sponsors and originator credit institutions

190. Some respondents mentioned that the AIFM would in practice not be able to ensure that the sponsors or originators fulfil the requirements under Box 36 and considered these requirements too burdensome and going beyond what is required under the CRD. Other respondents noted that whereas Box 36 contemplates the imposition of requirements on AIFM and UCITS, the corresponding CRD provisions apply directly to credit institutions in their capacity as originator, sponsor or credit grantor.

191. Some hedge funds managers' representatives were of the opinion that where there is a public listing, the requirement of ensuring adequate standards of credit policy could be deemed to be given in the offering circular.

ESMA's response: For the reasons mentioned above under Box 35, ESMA did not consider appropriate to modify the requirements under Box 36. However, ESMA believed appropriate to clarify in the explanatory text that if the information required under Box 36 was given in the offering circular or the prospectus, if existing, the AIFM could rely on that information and would not be obliged to approach the sponsor, originator credit institution or original lender (as applicable).

Box 37 – Requirements for transparency and disclosure of retention

192. Some respondents noted that whereas Box 37 required AIFM and UCITS (as investors) to ensure that certain disclosures are made by sponsors, originators and original lenders, under the CRD a disclosure obligation was imposed directly on sponsor and originator credit institutions and the CEBS guidelines indicated that credit institution investors should not invest in securitisations unless they considered that they had access to the relevant information for the purposes of satisfying their due diligence requirements.

ESMA's response: For the reasons mentioned above under Box 35, ESMA did not consider appropriate to modify the requirements under Box 36.

Box 38 – Requirements for risk and liquidity management

193. Some asset managers were of the opinion that Box 38 reflected the general principles of risk management and, therefore, should either be deleted or tied in with the relevant implementing provisions on risk management.

ESMA's response: ESMA considered appropriate to keep Box 38 to the extent that, whereas partially based on the general provisions of Article 15(2) of the AIFMD, it put a particular focus on the ALM, concentration and investment risk.

Box 39 – Requirements for monitoring procedures

194. Some asset managers suggested modifying the last sentence in Box 39 since 'Issuer name and credit quality' are no categories of securitisation tranches.

195. Some hedge funds managers' representatives questioned the feasibility of the compliance with the relevant requirement for smaller AIF.

ESMA's response: Given the limited amount of feedback received, ESMA understood that the content of the box was generally agreed by stakeholders and decided not to introduce any amendment to its content.

Box 40 – Requirements for stress tests

196. Some asset managers suggested linking the provisions in Box 40 to the general requirements for risk measurement and stress testing proposed in Box 28 in order to ensure a consistent approach to the AIF risk management.

ESMA's response: Given the limited amount of feedback received, ESMA understood that the content of the box was generally agreed by stakeholders and decided not to introduce any amendment to its content.

Box 41 – Requirements for formal policies, procedures and reporting

197. A few respondents asked for clarifications on the sanctions, if any, for failure to comply with the relevant requirements.

ESMA's response: Given the limited amount of feedback received, ESMA understood that the content of the box was generally agreed by stakeholders and decided not to introduce any amendment to its content.

Box 42 – Introduction of new underlying exposures to existing securitisations

198. Some asset managers called for the introduction of grandfathering provisions for investments in positions between 1 January 2011 and the entry into force of the implementing measures of the AIFMD and suggested that a transitional period should be granted to AIFM for dispositions of investments held by AIF at the entry into force of the new rules.

199. Some hedge funds managers' representatives were of the opinion that it would not be appropriate to follow the CRD approach by introducing an equivalent 2014 deadline and it would be preferable not to impose the 2014 provisions on AIFs so that AIFs would not be forced to sell their securitisations in case they do not find an appropriate person to retain the 5% interest, thus helping to maintain price stability and liquidity.

200. The same hedge funds managers' representatives asked for the introduction of a clear provision (similar to CRD provisions) stating that all the requirements, including the qualitative requirements mentioned under article 17(b) of the AIFMD, are to be applied only to securitisations issued after 1 January 2011.

ESMA's response: ESMA did not consider appropriate to introduce any amendment to the grandfathering provisions of Box 42 to the extent that these are aligned on the relevant CRD provisions and the CEIOPS' advice and should be interpreted in the light of the CEBS Guidelines for interpreting the respective grandfathering provisions of the CRD, thus ensuring cross-sectorial consistency.

Box 43 – Investments by UCITS

201. Respondents expressed a general agreement on the alignment of the UCITS requirements with those set out for AIFM.

ESMA's response: In light of the general consensus received from the respondents to the consultation, ESMA decided not to introduce any amendment to the content of Box 43.

IV.VII. Possible Implementing Measures on Organisational Requirements

General comments

202. Some real estate representatives considered inefficient to apply additional organisational requirements under the AIFMD implementing measures to listed property companies which are already subject to extensive EU and national rules and best practice guidance in relation to corporate governance, reporting, transparency and disclosure.

203. Other real estate representatives did not have any comments on the rules on the organisational requirements since industry practices are largely consistent with the foreseen requirements.

ESMA's response: Given the mixed views received from respondents, ESMA considered that there was no evidence that the organisational requirements set out in the advice (broadly reflecting the UCITS and MiFID Level 2 measures) were inappropriate.

Box 44 – General requirements on procedures and organisation

204. Several asset managers asked to clarify that the proportionality principle should be employed in applying all the implementing measures in Box 44, not only those at paragraph 1 of the Box 44.

ESMA's response: ESMA decided not to introduce any amendment to the provisions of Box 44 which introduced the proportionality principle in a manner which was consistent with the approach taken under the UCITS and MiFID Level 2 measures.

Box 45 – Resources

205. Private equity representatives welcomed the introduction of the proportionality principle within the provisions of Box 45.

206. With reference to paragraph 3 of Box 45, some asset managers asked for clarifying that smaller AIFMs should be allowed to have less extensive human and technical resources than those required to larger AIFMs.

ESMA's response: Given the feedback received from the respondents to the consultation, ESMA decided not to introduce any amendment to the content of Box 45.

Box 46 – Electronic data processing

207. With reference to the requirement for 'appropriate arrangements' at paragraph 1 of Box 46, several asset managers asked for the introduction of a reference to the proportionality principle.

208. Private equity and venture capital representatives asked to replace the reference to 'electronic systems' with a more generic reference to 'systems' as private equity and venture capital AIFM usually record transactions in paper form and to exclude any record obligation whenever the transaction is managed by a third party.

ESMA's response: ESMA decided not to introduce any amendment to the provisions of Box 46 considering that the approach taken was consistent with the one taken under the UCITS and MiFID Level 2 measures.

Box 47 – Accounting procedures

209. Several asset managers called for the insertion of a reference to the proportionality principle.

210. Some hedge funds managers' representatives mentioned that Box 47 seemed to imply that the AIFM would maintain the accounts, which is incorrect.

211. Private equity and venture capital representatives suggested clarifying that AIFM should have the flexibility to determine the accounting standards used for an AIF (e.g. U.S. GAAP and non-statutory accounting standards) without having to prepare two sets of accounts for each investor base (i.e. one consolidating and one non-consolidating the AIFM's fund or portfolio companies in the presentation of the accounts).

ESMA's response: ESMA decided not to introduce any amendment to the provisions of Box 47 considering that the approach taken was consistent with the one adopted under the UCITS and MiFID Level 2 measures. In particular, ESMA wishes to clarify that Article 22(3) of the AIFMD provides that the AIF's annual report shall be prepared in accordance with the accounting standards of the home Member State of the AIF or in accordance with the accounting standards of the third country where the AIF is established and with the accounting rules laid down in the AIF rules or instruments of incorporation. Therefore, the accounting standards to be used shall be determined according to the aforementioned Level 1 rules.

Box 48 – Control by senior management and supervisory function

212. Private equity and venture capital representatives welcomed the fact that the text of Box 48 is neutral on the identity of the individuals or body which performs the senior management and supervisory functions of the AIFM. They also requested the insertion of a reference to the proportionality principle in Box 48.

213. Some asset managers mentioned that the requirement to have the senior management approval and review was too strict and suggest introducing the possibility to also have approval and review by middle management.

214. Certain hedge funds managers' representatives mentioned that the text should be tailored to provide for other legal forms, such as limited liability partnerships, where there are no directors, but partners.

215. The same hedge funds managers' representatives asked for (i) deleting the reference to non-executive directors from paragraph 12 of the relevant explanatory text since they should not have this role (as non-executive) and (ii) for deleting paragraph 2(b) of Box 48 or alternatively amending it for taking into consideration the fact that the investment strategies or policies may not be set by the manager but at the level of the AIF.

ESMA's response: ESMA decided to align more closely the provisions of Box 48 with the ones of the UCITS Level 2 measures and thus saw merit in deleting the reference to the AIFM's senior management approval of the investment strategies of each managed AIF and in deleting the distinction between national systems which provide for the dual board system and national system which do not provide for such a system for the purposes of the definition of the term 'supervisory function' in the explanatory text. ESMA did not consider appropriate to introduce the remaining amendments suggested by the respondents mainly since they would not be in line with the corresponding UCITS Level 2 measures.

Box 49 – Permanent compliance function

216. Several respondents (including asset managers and institutional investors) asked for the introduction in the text of Box 49 of the clarification (included in the explanatory text only – paragraph 15) that it was not requested to establish an independent compliance unit if this would be disproportionate for the AIFM.

ESMA's response: ESMA did not consider necessary to insert a specific reference to the proportionality principle in the text of the box to the extent that the explanatory text already included a specific reference to such principle and decided to keep the text of the box which reflected the corresponding UCITS Level 2 measures.

Box 50 – Permanent internal audit function

217. Some asset managers and institutional investors recommended the inclusion of an option to outsource the permanent internal audit function.

218. Some hedge funds managers' representatives suggested amending paragraph 1 of Box 50 to make clear that, as mentioned in the relevant explanatory text, in case the separation and independence of the audit function from other functions is disproportionate, the audit function shall be carried out by another business unit of the AIFM.

219. One respondent asked to delete Box 50 since its provisions were unnecessary and too detailed and the need for proper processes to review an AIFM's systems, internal control mechanisms and arrangements was already satisfied by the compliance function covered by Box 49.

ESMA's response: To the extent that reference to the proportionality principle was already made in the text of Box 50, ESMA did not consider necessary to insert any further amendment to the content of this box nor to delete it since it was not unnecessary and reflected the corresponding UCITS Level 2 measures.

Box 51 – Personal transactions

220. Some respondents were concerned by the fact that due to the definition of 'relevant person' more types of persons would fall under the scope of the personal transactions rules and proposed to limit the scope of the rules.

221. Real estate representatives mentioned that it was usual that managers and other relevant persons participated in in-house non-tradable closed-ended funds and felt the ban of such kind of investments as unsatisfactory since it should be sufficient simply to advise other investors of such participating persons. In case the current proposal was kept, the said respondents asked to clarify that that existing investments held by the relevant persons in non-tradable closed-ended funds were not covered by the scope of this provision, given the grand-fathering clause for non-tradable closed-ended funds under article 61(3) of the AIFMD.

222. Private equity representatives asked to delete the reference to 'other assets' under paragraph 1(b) of Box 51 since this would involve applying public market standards to private investments; such reference could be replaced with a reference to 'partnership interests' which in a number of jurisdictions are already treated as included in financial instruments.

223. The same private equity representatives suggested introducing a system that notifies individuals of their obligations in respect of personal transactions, coupled with a self-certification system in respect of such transactions (paragraph 2(a) and (b) of Box 51), and asked to clarify that for the requirements of Box 51 the proportionality principle shall apply.

224. Some asset managers suggested clarifying in paragraph 4 of Box 51 that the obligation should only apply if the assets are relevant to the concerned AIF.

ESMA's response: ESMA acknowledged the comments made by the respondents and was of the opinion that there was no adequate rationale for diverging from the relevant UCITS Level 2 measures on personal transactions other than for including not only personal transactions with financial instruments but also personal transactions with other assets. Therefore, ESMA decided to keep the text of the box without amendments.

Box 52 – Recording of portfolio transactions

225. Hedge funds managers' representatives considered the proposal as a sensible adaptation of the UCITS directive requirements.

226. Private equity and venture capital representatives mentioned that the proposed recording provisions were inapplicable and irrelevant to private equity and venture capital funds and therefore suggested to tailor them by making a distinction between transactions which take place on an execution venue and transactions which take place outside an execution venue.

227. Some respondents pointed out that Box 52 did not take into account the variety of AIFM that may be required to keep records or the type of assets which they are dealing in (e.g. a self-managed AIF managing its own money on behalf of its own shareholders) and suggested that paragraph 2 should be made optional and the list under paragraph 2(a) to (i) should be indicative only.

228. Some asset managers and institutional investors' representatives asked for the insertion of a reference to the proportionality principle in Box 52.

ESMA's response: ESMA considered appropriate to make a distinction in the recording requirements depending on the type of assets and saw merit in the request to make a distinction between transactions which take place on an execution venue and transactions which take place outside an execution venue. Therefore, ESMA decided to introduce the relevant distinction and to provide for appropriately differentiated recording requirements for transactions which take place outside an execution venue.

ESMA did not consider appropriate to introduce the proportionality principle within the provisions of Box 52 since, whereas a differentiation based on the type of assets appeared adequate, the recording obligations should apply whichever the size of the AIFM and the nature of its business are.

Box 53 – Recording of subscription and redemption orders

229. Some stakeholders pointed out that the requirements were only applicable to the direct distribution by the AIF and that different solutions regarding the recording of orders should be permitted in case of indirect distribution or trading on a secondary market. Similarly, private equity and venture capital representatives pointed out that the requirements of Box 53 were designated for traded and liquid open-ended funds and are irrelevant in the context of closed-ended funds.

230. The same private equity and venture capital representatives asked for the insertion of a reference to the proportionality principle in Box 53.

231. Some hedge funds managers' representatives were of the opinion that paragraph 2(i) of Box 53 should refer to drawn and undrawn commitments and the words 'and paid' should be deleted accordingly.

ESMA's response: ESMA acknowledged the comments received from respondents arguing that the recording requirements were not relevant for indirect distribution or trading on a secondary market as well as for closed-ended funds. However, ESMA did not consider necessary to introduce any amendment to the content of the box to the extent that the recording obligations should apply to any kind of funds as far as an AIF subscription and, where relevant, redemption occurred.

ESMA did not consider appropriate to introduce the proportionality principle within the provisions of Box 53 since the recording obligations should apply whichever the size of the AIFM and the nature of its business are.

The reference to the 'amount of capital committed and paid' was inserted to cover private equity AIF where there is no subscription price for each unit, but rather a commitment to invest. ESMA considered that no adequate evidence was provided by the respondents asking to include undrawn commitments in the recording obligations and, therefore, decided not to amend the box on this point.

Box 54 – Recordkeeping requirements

232. Hedge funds managers' representatives considered the proposal as a sensible adaptation of the UCITS directive requirements.

233. Some stakeholders pointed out that the requirements were only applicable to the direct distribution by the AIF and that different solutions regarding the recordkeeping of orders should be permitted in case of indirect distribution or trading on a secondary market.

234. Some private equity and venture capital representatives asked for the insertion of a reference to the proportionality principle in Box 54, noting, in particular, that the requirements in paragraph 3 are irrelevant to a typical private equity or venture capital AIFM or AIF.

ESMA's response: ESMA acknowledged the comments received from respondents arguing that the recordkeeping requirements were not relevant for indirect distribution or trading on a secondary market. However, for the same reasons mentioned under Box 53 above, ESMA did not consider necessary to introduce any amendment to the content of the box.

ESMA did not consider appropriate to introduce the proportionality principle within the provisions of Box 54 since the recordkeeping obligations should apply whichever the size of the AIFM and the nature of its business are.

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?

235. The large majority of respondents did not consider that a requirement for complaints handling should be included for situations where an individual portfolio manager invested in an AIF on behalf of a retail client. Some of the respondents explained that adequate procedures for complaint handling were already provided for by MiFID provisions which apply to the relationship between the AIF and its investors.

ESMA's response: In light of the feedback received from respondents who clearly rejected the idea of introducing a requirement for complaints handling for situations where an individual portfolio manager invested in an AIF on behalf of a retail client, ESMA took the decision not to introduce such requirement.

IV.VIII. Possible Implementing Measures on Valuation

General comments

236. There was a general agreement on the valuation framework set out in the proposal and some institutional investors specifically welcomed the fact that it can be adapted to the specific characteristics of the diverse type of assets in which an AIF may invest.

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

237. Some respondents were concerned by the fact that paragraph 2 of Box 55 could be read to require a single approach to the valuation of a specific legal type of asset in all circumstances by the AIFM (whereas AIFMs may use a number of different methods of valuation of the AIFs'

assets) and asked to modify such paragraph as follows: ‘An AIFM shall not invest in a particular type of asset for the first time unless appropriate valuation methodologies have been identified’.

238. Some private equity and venture capital representatives asked to replace the word ‘Where’ at the beginning of paragraphs 4 and 5 of Box 55 with the words ‘To the extent that’ in order to reflect not only the fact (already covered by paragraph 11 of the explanatory text) that an AIFM may appoint several external valuers, but also that an AIFM may opt for a combination of approaches (internal and external valuation of AIF assets).

239. One stakeholder asked to modify paragraph 11 of the explanatory text under Box 55 in order to provide that the external manager may be appointed by the AIF when there is actual internal management and not ‘where the legal form of the AIF permits an internal management’ as it is currently foreseen.

240. Real estate representatives expressed a general agreement on the rules set out in the box.

ESMA’s response: ESMA agreed on the necessity to clarify that the AIFM was not required to adopt a single approach to the valuation of a specific legal type of asset in all circumstances, but instead it shall not invest in a particular type of asset for the first time unless appropriate valuation methodologies have been identified.

Given the feedback received, ESMA felt also appropriate to specify that the external manager may be appointed by the AIF when there is actual internal management.

ESMA did not see any merit in replacing the word ‘Where’ at the beginning of paragraphs 4 and 5 of Box 55 with the words ‘To the extent that’.

Box 56 – Models used to value assets

241. Some respondents asked to clarify that the person validating the model according to paragraph 2 of Box 56 might be an internal or external person.

ESMA’s response: ESMA saw merit in providing the clarification requested by the respondents and modified the explanatory text accordingly.

Box 57 – Consistent application of the valuation methodologies

242. While some respondents supported the proposal noting only that there might legitimately be considerable variation between valuation policies and procedures used in relation to several AIFs managed by the same AIFM, other respondents considered burdensome and not feasible that policies and procedures should be applied across all AIF having the same AIFM (in particular because AIFM often manage AIF located in different jurisdictions which are subject to the local valuation rules and requirements) and that valuation sources and rules should remain consistent over time. Therefore, some of the respondents suggested deleting paragraph 2 of Box 57 or alternatively (i) to insert the clarification currently in the explanatory text according to which the application of consistency should take into account the existence of different external valuers and

(ii) to allow for different accounting standards and different pricing sources to be applied across different AIFs being managed.

ESMA's response: Without any prejudice of the requirement of ensuring a consistent application of valuation methodologies which shall remain applicable in its entirety, ESMA recognised the opportunity to delete the second sentence under paragraph 2 of Box 57 requiring that the policies and procedures shall be applied across all AIF having the same AIFM.

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

243. Several respondents supported the content of Box 58 and the relevant explanatory text.

244. Some private equity and venture capital representatives suggested amending the wording of the Box in order to replace the annual review requirement with some provisions reflecting the best practice of the private equity/venture capital sector in relation with the material changes to valuation policies and procedures.

ESMA's response: ESMA did not see the merit of amending the frequency of the policies and procedures' review and decided not to make any amendment to the content of the box, also considering the general support it received.

Box 59 – Review of individual values

245. Most of respondents did not express any concern in relation to the requirements of Box 59.

246. Some respondents considered the requirements of Box 59 excessively burdensome, in particular considering that, if an external valuer was appointed, the AIFM should be able to rely on the values provided by the valuer, in line with the text of the AIFMD which did not require any further clarification. They asked some consequent amendments and deletions within the Box to address their concerns.

247. A private equity and venture capital association proposed some amendments to the content of Box 59 in order to clarify that the AIFM should not be required to undertake a methodical review of its (or its external valuer's) conclusions with respect to valuation for each asset, but such review should be limited to the occurrence of changing facts or circumstances.

248. One stakeholder asked to clarify that the comment on the valuation of illiquid assets under paragraph 18 of the explanatory text did not refer to all 'other assets' as defined under article 21(8)(b) of the AIFMD and that valuation of physical assets such as real estate, ships and aircrafts are by no means more subject to error in spite of the illiquid nature of the assets.

ESMA's response: Given that the majority of respondents did not raise any specific concern as regards the requirements of Box 59, ESMA felt appropriate to keep the requirements of the box substantially unchanged, but, in the light of the feedback received, saw merit in clarifying that the AIFM has to document by type of assets the way the appropriateness and fairness of the individual values is assessed, meaning that it has not to mandatorily perform its own assessment.

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

249. A couple of private equity and venture capital and real estate associations asked to replace the word ‘The’ at the beginning of each paragraph of Box 60 with the words ‘Where relevant, the’, in order to reflect the fact that private equity/venture capital or real estate AIF structured as limited partnerships do not issue shares or units of the sort contemplated by the Level 1 directive and there is no issue or subscription or redemption of shares in case of draw dawns or distribution of realisation proceeds or other income.

250. An institutional investor and an asset managers’ association mentioned that, according to article 19(4) and (7) of the AIFMD, the governing body of an AIF that has appointed an external AIFM may also appoint an external valuer and suggested to amend paragraph 23 of the explanatory text accordingly (the text read as follows: ‘The AIFM is always responsible for … where appropriate the appointment of an external valuer’).

251. Several respondents agreed with the statement in paragraph 24 of the explanatory text under Box 60, whereas one stakeholder considered that the statement in paragraph 24 of the explanatory text according to which a third party which calculates the net asset value of an AIF based on values obtained from the AIFM, pricing sources or values obtained from an external valuer is not an external valuer, was not in line with the provisions of the Level 1 directive.

ESMA’s response: ESMA did not consider appropriate to modify the text of paragraph 1 of Box 60 to take into account the comment made by the private equity and venture capital and real estate representatives, but clarified that the requirement applies for each issue or subscription or redemption or cancellation of units or shares. The requirements would therefore not apply in case such activities are not carried out.

ESMA decided not to amend paragraph 23 of the explanatory text since the reference to the appointment of the external valuer by the AIFM did not foresee an appointment by the AIFM in all circumstances but only ‘where appropriate’.

ESMA did not agree with the comment made by one respondent and considered that the statement in paragraph 24 of the explanatory text under Box 60 according to which a third party which calculates the net asset value of an AIF based on values obtained from the AIFM, pricing sources or values obtained from an external valuer is not an external valuer, was in line with the provisions of the Level 1 directive. However, ESMA saw merit in clarifying that the valuations for individual assets that the third party entity carrying out the calculation of the net asset value for an AIF shall not provide in order not to be considered an external valuer include those requiring subjective judgement.

Box 61 – Professional guarantees

252. The majority of respondents welcomed the proposal in Box 61.

253. A depositaries' association was of the opinion that the reference to the fact that the professional guarantees should include evidence of the valuer's qualification and capability to perform the valuation function left too much room for a divergent approach by Member States.

254. The same association mentioned that in the consultation paper there was not mention of the possibility to appoint the depository as an external valuer and asked to clarify whether in case of such an appointment the depositary would have to provide the same professional guarantees.

255. Finally, the said association was concerned by the provision of the Level 1 directive according to which the appointed external valuer may not delegate the valuation function to a third party (article 19(6) of the AIFMD): if the external valuer is the depository such provision would be problematic since the valuation of some asset classes is performed by the dedicated entities and/or department of the depository group.

ESMA's response: Given the general support received from respondents, ESMA did not feel appropriate to amend the content of Box 61 to introduce any further clarification.

ESMA believes that the professional guarantees requirements should apply to any appointed external valuer. As for the impossibility for the external valuer to delegate the valuation function to a third party, ESMA recalls that, as pointed out by the concerned respondent, the prohibition comes from the Level 1 provisions.

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

256. Respondents generally supported the content of Box 62. A couple of respondents asked to clarify in Box 62 that it applies to open-ended funds only.

ESMA's response: ESMA decided not to include any further clarification in the content of the Box, given that its title clearly referred to open-ended funds.

IV. IX. Possible Implementing Measures on Delegation

Box 63 – Delegation

257. Several respondents requested more precise guidance on which functions should be considered 'critical and important' and which should be considered 'supporting tasks'. Some of them requested the inclusion of paragraphs 9 and 11 of the explanatory text under Box 63 directly into the text of Box 63, in particular since they provided a crucial interpretation of the term 'critical and important functions'. Other respondents asked for the introduction of the words '(other than supporting tasks)' after 'functions' in the last line of paragraph 1 of Box 63 and for clarifying (without prejudice to the provisions on valuation under article 19 of the AIFMD) that all the functions set out in paragraph 2 of Annex I of the AIFMD constitute 'supporting tasks' to which the provisions of article 20 of the AIFMD do not apply. A couple of stakeholders recommended

clearly designating IT suppliers and similar support as providers of 'supporting tasks' not subject to the delegation rules.

258. There were some comments highlighting that the services mentioned in Box 63 did not involve delegating any function since they did not relate to a function which the AIFM has responsibility for in the first place and asking to modify paragraph 3(a) of Box 63 to specify that the list of functions which should not be considered as critical or important for the purposes of Box 63 is not exhaustive and to include into such list a reference to the provision of accounting, audit, marketing and corporate finance, tax and financial advice.

259. One respondent requested to clarify that article 20 of the AIFMD should not apply where the AIF has directly appointed someone other than the AIFM to perform a particular task.

ESMA's response: Notwithstanding certain of the comments received from the respondents, ESMA decided not to modify the content of Box 63 since it considered that Box 63 and its explanatory text provided sufficiently detailed rules to determine which functions shall be regarded as 'critical and important' and which as 'supporting tasks'. In particular, ESMA did not include in the text of the Box the list of arrangement or activities which are unlikely to constitute delegation or, if they constitute delegation, are unlikely to constitute delegation of 'critical and important' functions since, given the nature of such indicative list, ESMA felt more appropriate to keep it in the explanatory text. Furthermore, EMSA disagreed with the request to include IT support with the 'supporting tasks' since such support may be crucial for the activities of the AIFM.

Finally, ESMA believes that the content of Box 63 clearly states that the delegation rules should apply in case of delegation of a task which would otherwise be undertaken by the AIFM (i.e. not task which the AIFM is not responsible for).

Box 64 – General principles

260. Several respondents appreciated the content of Box 64.

261. An investment managers' association suggested deleting the words 'in particular' from paragraph 1 of Box 64 and asked for aligning the provisions with those under the MiFID framework by requiring AIFM only to take necessary steps to ensure that the conditions are met. An institutional investor's association similarly asked to clarify that AIFMs are required to 'make reasonable efforts' with regard the general principles.

262. One respondent suggested replacing the word 'guaranteed' with the word 'maintained' (which better describes the outcome the AIFM should secure) under paragraph 1(f) of Box 64.

263. Another respondent suggested either deleting the first sentence of paragraph 1(e) of Box 64 or cross-referring to the provisions relating to letter box entities under Box 73 since there is an overlap between these provisions.

264. A couple of stakeholders asked to clarify under paragraph 1(h) of Box 64 that the delegate should keep some discretion in implementing the investment policy, notwithstanding the instructions of the AIFM.

ESMA's response: Given the general support on the content of Box 64, ESMA did not agree with the requests to amend it, in particular with those asking to align it with the provisions under the MiFID framework since it believed that the provisions of the box were already aligned with those of Article 14 of MiFID Level 2. However, for the reasons mentioned by the relevant respondent, ESMA saw merit in the suggestion to replace the word 'guaranteed' with the word 'maintained' under paragraph 1(f) of Box 64.

Box 65 – Objective Reasons

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

265. The majority of respondents preferred option 1 in Box 65. Some of them mentioned that option 1 provided a general rule which might be applied in a flexible manner and was more in line with the UCITS approach. A respondent added that it would be misleading to state only few examples of objective reasons which would give no guidance but rather be confusing. Another respondent was afraid that national supervisors could regard option 2 as an exhaustive list of legitimate objective reasons for delegation.

266. Several respondents preferred option 2 in Box 65 since it set out a number of the key reasons why the delegation might be used while recognising that there might be other satisfactory justifications for delegation.

267. A relevant number of respondents considered that option 1 and option 2 in Box 65 could be combined (some of them suggested this solution as an alternative to the adoption of option 2): option 2 could provide an indicative non-exhaustive list of rationales to qualify as objective reason for delegation under option 1.

ESMA's response: Given the mixed views expressed by the respondents to the consultation, ESMA decided to opt for the combination of option 1 and option 2 in Box 65 which represented a solution taking into due account the feedback received and should be satisfactory for the achievement of the relevant regulatory purposes..

Box 66 – Sufficient resources and experience and sufficiently good repute of the delegate

268. An asset managers' association disagreed with the requirements of Box 66 and asked for a closer alignment with the MiFID and UCITS relevant provisions.

269. A private equity representative mentioned that the list of requirements under Box 66 should be an indicative list and that some proportionality should be introduced in order to consider the size, scale and nature of the AIFM versus the identity of the service provider.

270. A respondent asked for providing explicitly that, whenever the AIFM delegates its functions to one of the entities listed in Box 67, the requirements under paragraphs 2 to 4 in Box 66 shall be deemed to be fulfilled. Other respondents mentioned that the AIFM should be able to rely on the professional status of the delegate in circumstances where it is regulated within the EU or a third country. Similarly, one stakeholder was of the opinion that where the delegate is an authorised firm, the AIFM should be able to rely on the authorisation and perform the additional checks that it believe necessary depending on the specific circumstance of the case and the functions delegated.

271. An asset managers' association suggested deleting the reference to 'theoretical knowledge' under paragraph 3 of Box 66 as unclear.

272. Several respondents asked to introduce some proportionality as for the requirement under paragraph 4 instead of introducing an absolute prohibition in case of criminal offences, judicial proceedings or administrative sanctions. Some of them asked to allow the AIFM to rely upon a confirmation of the delegate concerning the absence of negative records relevant to the performance of the delegated tasks. Other respondents asked for introducing into the Level 2 measures the text of paragraph 29 of the relevant explanatory text. It was also asked to amend paragraph 4 to allow to the appointed legal person to contractually guarantee the reliability of the staff acting on its behalf.

ESMA's response: Given the feedback received from the respondents to the consultation, ESMA decided to modify the content of the box to provide that the list of checks to be performed by the AIFM in relation to the sufficient resources and experience and sufficiently good repute of the delegate represents an indicative list.

273. ESMA considered the reference to 'theoretical knowledge' under paragraph 3 of Box 66 as sufficiently clear and did not see merit in deleting it.

274. ESMA agreed on the fact that whenever the delegate is a regulated entity, the AIFM may assume that the persons who effectively conduct the business of the delegate are of sufficiently good repute. However, ESMA decided to limit such presumption to entity regulated within the EU and that the presumption shall not cover the requirements relating to the sufficient resources of the delegate and the sufficient experience of the persons who effectively conduct the business of the delegate: these requirements should be checked by the AIFM on a case by case basis.

275. ESMA decided to modify the requirements of paragraph 4 in order not to introduce an absolute prohibition in case of criminal offences, judicial proceedings or administrative sanctions.

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

276. Several respondents welcomed the proposal in Box 67.

277. An asset managers' association proposed to include in the list also other institutions to the extent they are subject to similar regulatory requirements under national laws (e.g. German 'Anlageverwaltung' is subject to regulation similar to a portfolio manager under MiFID).

278. One respondent considered that the possibility for management companies to delegate to credit institutions could lead to regulatory arbitrage ad that delegation should be allowed to entities authorised for investment management.

ESMA's response: Given the general support received on the proposal, ESMA did not consider appropriate to broaden or limit the scope of Box 67.

Box 68 – A delegation would prevent the effective supervision of the AIFM, or the AIFM from acting, or the AIF from being managed, in the best interest of its investors in particular under the following circumstances:

279. One respondent asked to refer to the 'AIF' only in paragraph 2 of Box 68 instead of to the 'AIFM or the investors of the AIF' since the Level 1 directive recognised that the AIFM's duties are to the AIF, not to the AIF's investors.

ESMA's response: ESMA did not agree with the proposal since the reference to the best interests of the AIF's investors was explicitly made in Article 20(1)(e) of the AIFMD.

Box 69 – Sub-delegation – General principles

280. Respondents generally agreed with the content of Box 69.

ESMA's response: Given the support received, ESMA kept the content of Box 68 without any amendment.

Box 70 – Type of evidence necessary for an AIFM to demonstrate its consent to sub-delegation

281. Respondents generally agreed with the content of Box 70.

282. Some stakeholders mentioned that the requirement to demonstrate the consent of the AIFM to each sub-delegation in writing seemed to be unnecessary if the general delegation agreement is clear with regards to the permitted sub-delegation.

ESMA's response: Given the general support received, ESMA kept the requirement to evidence the AIFM's consent to each sub-delegation in writing.

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

283. Some respondents asked for clarifying that the requirement of independence in paragraph 2(a) of Box 71 referred to the independence between the portfolio management function and the risk management function.

284. A hedge funds managers' association asked:

(i) to clarify that the references to investors in an AIF represented references to such investors in their capacity as investors in the AIF,

(ii) to clarify what was meant by 'controlling tasks' and 'operating tasks' and whether the examples under paragraph 43 of the explanatory text could be used, and

(iii) how the concept of proportionality is to be applied under paragraph 2 of Box 71 in the context of what appeared to be four absolute requirements (i.e. items (a) to (d) under paragraph 2).

285. One respondent asked for the deletion of the reference to the investors of the AIF under paragraph 1 of Box 71.

ESMA's response: ESMA did not agree with the request to clarify that the requirement of independence in paragraph 2(a) of Box 71 referred to the independence between the portfolio management function and the risk management function since the intention was to refer to controlling tasks which are broader than risk management tasks.

20. As for the residual requests of clarification of the content of the box, ESMA did not see the necessity to introduce any amendment since the relevant provisions were already sufficiently clear.

21. The reference to the investors of the AIF was kept to the extent that it reflected the provisions of Article 20(5)(b) of the AIFMD.

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

286. Respondents generally agreed with the content of Box 72.

287. One respondent suggested that, as for the delegated tasks, a brief outline should suffice for the purposes of the notification and also requested the introduction of a timeframe for the submission of the notification.

ESMA's response: Given the general support received, ESMA did not consider appropriate to amend the content of Box 72.

22. As for the timeframe of the submission of the notification, ESMA refers to the provisions of Article 20(4)(b) of the AIFMD which provides that the notification shall occur before the sub-delegation arrangements become effective.

Box 73 – Letter-box entity

288. Respondents generally agreed with the content of Box 73.

289. A private equity association mentioned that the proposal on letter-box entity should not mean that an AIF cannot delegate key functions and asked for deleting item 2 of Box 73.

290. A respondent asked to clarify that a power contained in the AIF's constitution or in a contract between the AIFM and its delegate should suffice to satisfy the condition under paragraph 2 of Box 73.

291. Another respondent mentioned that it would be difficult for an AIFM to become a letter-box entity given that the AIFMD provided that certain functions may not be delegated and responsibility rests with the AIFM; the same respondent suggested that a statement of auditors in the annual audit of the AIFM indicating that they have reviewed/monitored the delegation arrangements should be sufficient to evidence that the entity has not become a letter-box.

ESMA's response: Given the general support received, ESMA did not consider appropriate to amend the content of Box 73.

In the meantime, ESMA clarifies that, provided that the delegation arrangements comply with the relevant delegation rules, the letter-box provisions does not entail that an AIFM may not delegate its functions. ESMA does not consider sufficient a generic auditors' statement confirming that the AIFM is not a letter-box since the compliance with the relevant criteria should be specifically verified on an on-going basis.

Part V: Depositaries

General comments

292. There was some support among respondents for the notion of the depositary's controls applying at the first level only i.e. there should be no look-through approach to, for example, the cash flows of real estate operating and investment business in which the fund invests.

293. Several respondents stressed their preference for an approach based on ex-post controls, particularly with regards to oversight of 'other assets'.

294. One respondent noted that private equity (PE) and venture capital (VC) funds did not generally have depositaries as the nature of the investments had not made them a necessary or useful feature.

295. One association called for the AIFMD and UCITS requirements on oversight duties to be aligned.

296. One stakeholder felt that the L2 measures on depositaries should take due account of the specific role of CSDs and the specific clause in Article 21(10) of the Level 1. The same

respondent provided a helpful illustration of how fund depositaries may delegate the securities holdings and how segregation is generally implemented.

297. Looking at the impact of the requirements, one stakeholder was of the view that ESMA's proposals would increase costs by 4-5 times compared to the current regulatory framework, leading many hedge funds managers to relocate their business outside the EU or structure their arrangements with depositaries in such a way (i.e. using synthetic solutions) so as not to hold cash assets in custody. Another association was of the view that the proposals potentially increased systemic risk by leading to a concentration of depositary business among a much smaller number of entities, while two further associations considered that the proposals would effectively make depositaries insurers of the fund industry.

V.I – Appointment of a depositary

1. Contract evidencing appointment of the depositary

1.1 Particulars of the contract appointing the depositary

Box 74

298. The approach taken by ESMA was broadly supported by respondents. Two trade associations welcomed ESMA's approach of basing the requirements on the UCITS framework with a limited number of adaptations. Another association (large majority of members) also welcomed the fact that the list of particulars was non-exhaustive as this would in their view allow a good level of flexibility. In contrast, one stakeholder sought clarification that the list was in fact exhaustive.

299. One association felt that not all of the elements should be compulsory in all cases and should only be included where relevant.

23. **ESMA's response:** In light of the broad support for the approach taken in the draft advice, this has been confirmed in the final advice. More specific comments are addressed below. ESMA confirms that the list of particulars to be included in the contract is not meant to be exhaustive and that the parties have the option of adding further information.

300. The following specific comments or suggested amendments were made:

Paragraph 2

- 'A description of the type of assets that will fall within the scope of the depositary's **safekeeping and oversight** function...'.

- the description of the type of assets should also include a description of the geographic zones in which the AIF/AIFM plans to invest as this is an essential information to allow the depositary to fulfil its obligations, such as the requirement to assess and monitor custody risks.

- clarify whether paragraph 2 requires simply a list of the types of asset which may fall within the depositary's function as opposed to a wider description of each instrument.

24. **ESMA's response:** ESMA agrees with the suggestions made to clarify the advice and has made corresponding changes in the box and explanatory text.

Paragraph 3

- The text should make a more general reference to the L1 requirements to avoid any misconceptions.

- One stakeholder proposed an amendment (linked to its comments on Box 92) relating to the depositary's obligation to pursue recovery of any loss from its sub-custodians on behalf of the AIF/AIFM.

- It should be made clear that the depositary is not strictly liable for acts or omissions of its unaffiliated sub-custodian.

- The reference to 'objective reason' in the second part of paragraph 3 should be consistent with the advice in Box 92.

- Delete the last part of paragraph 3 in order to be consistent with meaning of 'objective reason to contract a discharge of liability' elsewhere.

25. **ESMA's response:** ESMA considers that the interaction of paragraph 3 with the Level 1 text is clear and has therefore made no changes in the final advice. Similarly, issues regarding liability are addressed in a specific section of the advice; as such, ESMA did not consider it appropriate to cover them here.

Paragraph 4

- The procedures by which any new depositary wishes to receive information will not be known at the time of drafting the agreement; the obligation should therefore be to inform the AIFM at the relevant time.

- The agreement should include a maximum time period during which the AIFM must appoint a new depositary and further details of the process to be followed in appointing the replacement depositary (paragraphs 6 and 7 of Box 74 could be used).

- Add a reference to 'the conditions which are necessary to facilitate transition to another depositary' in line with Article 33(c) of Directive 2010/43/EC and how the transfer of liability between the two depositaries works in such a scenario.

26. **ESMA's response:** ESMA recognises that not all the details on information will be transferred to the new depositary will be known at the time of drafting the agreement. However, it should be possible to set out the main elements of the procedure that will be followed. Regarding the appointment of the new depositary, ESMA did not wish to prescribe a timetable as this will depend on the individual circumstances. ESMA also highlights that the provisions of paragraph 4 are aimed at facilitating the transition to another depositary.

<u>Paragraph 7</u>

- This goes beyond the UCITS Directive and imposes an obligation on the AIFM which it could not necessarily always fulfil.
- In line with UCITS and paragraph 6 of Box 74, the parties should be allowed to include the necessary information in an SLA rather than the agreement itself.

27. **ESMA's response:** ESMA considers the requirements on exchange of information to be a crucial element of the depositary framework, particularly taking into account the strong liability that attaches to a depositary in the case of a loss of financial instruments. ESMA has therefore maintained the requirement that the depositary must have access to all the information it needs to fulfil its duties.

301. On the second point, ESMA has introduced general flexibility in the box to allow details to be included in the agreement itself or in a service level agreement.

<u>Paragraph 9</u>

- The consent of the depositary is not required for amendments to the AIF's rules.

28. **ESMA's response:** Paragraph 9 makes clear that the prior agreement of the depositary is not always required for changes to the AIF's rules.

<u>Paragraph 11</u>

- Two associations specifically supported this provision but one felt the scope should be extended to deal with further delegations so that the full custody chain is disclosed.

29. **ESMA's response:** Wording has been added to the explanatory text to clarify that the requirements in paragraph 11 apply to the whole of the custody chain.

<u>Paragraph 12</u>

- The requirement to provide 'all information (...)' is not sufficiently specific and should be replaced by a requirement to provide '(Relevant) Information regarding the tasks and responsibilities in respect of obligations relating to anti-money laundering and combating the financing of terrorism' (same wording as for items 8 and 13).

- 'all information' is too imprecise and should be replaced by 'information recording the allocation of task and responsibilities etc.'
- The text should reflect the situation in those MS (e.g. Italy) in which such obligations do not apply directly to the depositary.

30. **ESMA's response:** In light of the comments made, ESMA has aligned the text with the requirement in the UCITS Directive.

Paragraph 13

- The concept of effective opening of an account should be introduced i.e. when there is active use.

31. **ESMA's response:** ESMA recognised the need for clarification on the point at which the depositary should be informed of the opening of cash accounts. Rather than referring to 'effective opening', the final advice states that the information should be provided 'at' the opening of an account. ESMA has clarified in the explanatory text that the information should be provided as soon as possible after the opening of the account. This is aimed at allowing the depositary to exercise its cash monitoring duties properly.

Paragraph 14

- Details of the escalation procedures should be able to be included in an SLA rather than the agreement itself.

32. **ESMA's response:** As noted above, general flexibility has been introduced in the box in order to allow details to be included in the agreement itself or in a service level agreement.

Second-last sub-paragraph

- It is the duty of the competent authority, not the depositary, to oversee the AIFM's conduct of business.

33. **ESMA's response:** ESMA does not consider the duties on the depositary and the competent authority regarding the AIFM's conduct of business to be mutually exclusive (and indeed the Directive imposes requirements on both in this respect).

Explanatory text paragraph 10

- One respondent noted that the text was considerably more detailed than paragraph 4 of Box 74 and asked ESMA to clarify the minimum required content as regards termination of the contract.

34. **ESMA's response:** Paragraph 4 of the box and the explanatory text in paragraph 10 should be read together in order to clarify the minimum content of the agreement as regards termination of the contract.

302. One respondent felt that the list of particulars to be included in the agreement should also include an undertaking by the depositary to notify the AIFM when it becomes aware that the segregation of assets is not (or no longer) sufficient to ensure protection from insolvency of a sub-custodian in a specific jurisdiction. Similarly, another association called for an obligation to be included on the depositary to require its delegates, as far as is practicable, to comply with the segregation criteria in Box 89.

35. **ESMA's response:** ESMA agreed with the proposal to introduce a clear duty on the depositary to notify the AIFM when it becomes aware that the segregation of assets is not sufficient to ensure protection from insolvency of a sub-custodian in a specific jurisdiction (see new text in Box 89, Due diligence). On the second point, this is already addressed by paragraph 3 in Box 90 (Segregation obligation for third parties to which depositaries have delegated part or all of their safekeeping functions (based on Article 16 of Directive 2006/73/EC implementing the MiFID Directive)).

Additional remarks

303. There was general support for the approach whereby it will not be necessary to enter into a separate agreement for each AIF and rely on framework agreements instead, on the basis that this will reduce costs. One association sought more flexibility and highlighted the areas it thought would be more appropriately covered in an SLA (paragraphs 1, 7, 10, 12 and 13).

36. **ESMA's response:** As noted above, ESMA has introduced further flexibility on the use of service level agreements.

304. The majority of respondents supported ESMA's decision not to draft a model agreement.

37. **ESMA's response:** In light of the broad support for the proposed approach, ESMA has confirmed this in the final advice.

V.II Duties of the depositary

V.III Depositary functions

1. Depositary functions pursuant to §7 – Cash monitoring

1.1 Cash flow monitoring

Box 75 (Cash monitoring – general information requirements)

305. Several respondents broadly supported the proposals while making remarks on specific elements.

306. On the second bullet point, one association was of the view that the duty of the AIFM to inform the depositary prior to the opening of new cash accounts should not lead to an implication that the depositary has any influence in the choice of counterparties at which accounts are opened (in their view this remains an investment decision for the AIFM). Another association proposed that the depositary should be informed 'as soon as reasonably possible' of new cash accounts, noting that in some circumstances cash accounts may derive from implementation of investment decisions that require them to be opened prior to informing the depositary e.g. foreign exchange away from depositary, cash deposits with third-party institutions.

38. **ESMA's response:** ESMA has clarified the requirements in this context under Box 74 as well as in the feedback on that box. The duty of the AIFM to inform the depositary should not be seen as implying that the depositary has any influence in the choice of counterparties at which accounts are opened.

307. On the third bullet point, one association sought to limit the scope of the information to be provided to all 'necessary or relevant' information taking into account the main objective of the provision i.e. to enable timely access by the depositary to the cash account. Similarly, two real estate associations favoured limiting the obligation to 'material' information in order not to capture very small payments, which were likely to be common for real estate funds, while one representative of institutional investors favoured restricting to 'necessary' information. More generally, a depositary association suggested adding a reference in the last sub-paragraph to 'timely and accurate' information and clarifying that the information envisaged under the third bullet point should be defined in the contract appointing the depositary.

39. **ESMA's response:** ESMA did not consider it appropriate to limit the information to be provided in accordance with the third bullet point on the basis that this information is a key element in allowing the depositary to fulfil its duties.

308. Two investment management associations were of the view that the final sentence of Box 75 presented difficulties as it seemed to impose an obligation of result on the AIFM even though the AIFM may not have all the necessary information and the reference to Article 21 of the Directive was too broad. These associations favoured deletion of the sentence, or at least clarification of the scope of the AIFM's obligations.

40. **ESMA's response:** ESMA has taken on board the concerns raised and the sentence has been deleted from the final advice.

309. One investment management association felt that no liability should attach to depositary for failure on the part of the AIF/AIFM/third party provider to provide/procure accurate information; that the depositary's obligations must be understood as applying at the 'head' level of an AIF (i.e. at the level of cash accounts actually held by depositary as top level, 'global' cash accounts – and not at any other level); and that guidance should not be overly prescriptive as regards how the

depositary may discharge its obligation to ensure that an AIF's cash flows are properly monitored and should have regard to existing processes and procedures where possible.

41. **ESMA's response:** As noted above, issues of depositary liability are addressed in a separate section of the advice. Regarding the level at which the depositary's obligations apply, it should be understood from the wording of the box that the depositary must have access to all information regarding the AIF's cash accounts and have a clear overview of all the AIF's cash flows.

310. One depositary association favoured an amendment stating explicitly that where the depositary has not received the necessary information from the AIFM, the depositary is discharged from its liability provided it has exercised its responsibilities on the basis of the information made available to it.

42. **ESMA's response:** Issues of depositary liability are addressed elsewhere in ESMA's advice.

311. One real estate association sought clarification that the 2nd bullet point under paragraph 3 of the Explanatory text on p.147 (referring to 'consent') was only a descriptive statement that did not imply ex-ante consent. The same association questioned whether it was necessary for the third parties at which cash accounts are opened to provide the information directly to the depositary given that the explanatory text suggested that the information could be provided by the AIF/AIFM or another entity. Finally, the respondent disagreed with ESMA's decision to take a 'more conservative' approach to the cash booking requirements (c.f. paragraph 13 on p.151 of the CP) on the basis that this was inconsistent with Level 1 and, given the large number of small operational cash flows in real estate funds, it was more appropriate to limit to subscriptions and redemptions.

43. **ESMA's response:** On the first point, ESMA has deleted the reference to 'consent', while on the second ESMA has clarified that the information should be provided directly by the third party. On the final point, ESMA has carefully considered the consistency of such an approach with the Level 1. ESMA is of the view that the cash booking requirements should apply to all of the cash flows of the AIF; if this were limited to subscriptions and redemptions only, there is a risk that significant cash flows would not be monitored.

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

Q.29 Do you prefer option 1 or option 2 in Box 76? Please provide reasons for your view.

312. Most respondents had a clear preference for option 2; the following reasons were provided as justification:

- The requirement in option 1 to mirror transactions would be very expensive and duplicate the work of fund administrators.

- Option 1 would be operationally impractical and not appropriate from a PE perspective taking into account that commitments are called from investors for specific investments and cash returned upon realisation, rather than pools of money sitting in accounts for long periods.
- Option 1 (paragraph 2(c)) introduced an ex-ante concept which, if interpreted in line with paragraph 8 of the explanatory text, would effectively turn the depositary into a fund manager middle-officer.
- Explanatory-ante controls would interfere with the fundamental relationship between investor and manager.
- The depositary should be responsible for secondary level controls only and the importance of the first level of controls should be reaffirmed.
- Option 1 would involve the depositary becoming part of the primary process of payment and require it to keep track of every operating expense, however minor.
- Simultaneous control of all cash flows would cause substantial delays and derogation in the management, not least because of the extensive liability of the depositary.
- Option 1 would inappropriately restrict distribution options.
- It is not practical for an AIFM to ensure that instructions are sent simultaneously to the depositary and establishing systems would be particularly difficult where multiple bank accounts are involved.
- Option 2 is more proportionate and workable, the emphasis on proper procedures reflects the approach taken in respect of other depositary obligations, reduced duplication and is more cost-effective.
- Option 1 would be operationally challenging, costly and divert the depositary's attention from meaningful oversight and supervision.
- Option 1 would be extremely costly in terms of overhauling IT systems, impractical for depositaries given the number of cash movements (>100,000 per day), and the DVP settlement method provides sufficient protection in any case.
- Option 1 would relieve the AIFM of its duty to properly monitor its cash flows and shift the liability towards the depositary.
- The duplication of record keeping implied by option 1 is not necessary subject to effective systems and controls on which the depositary should have oversight.
- The monitoring required by option 2 would be sufficient to ensure a proper monitoring of all AIF's cash flows.

313. One depositary association could not support option 1 as a general rule but felt it could be acceptable in a limited number of MS and only for depositaries that also perform banking activities (further clarification would also be required on mirroring, particularly whether this was of every transaction or could be carried out ex-post on a regular basis, and whether subscription payments were covered). The same respondent accepted that mirroring cash transactions from the

AIF to the depositary would make sense from an economic and efficiency perspective where the appropriate technical infrastructure was already in place at the AIF and did not expect there to be a significant impact in terms of disruption to sales and/or administrative channels. Indeed, this respondent felt that option 1 – provided the ex-ante controls were limited to extraordinary cash movements of the AIF (e.g. 5 times the average) – would facilitate the depositary's control obligations and the co-operation between the AIFM and the depositary.

44. **ESMA's response:** In light of the broad support for option 2 and the arguments put forward by respondents, ESMA has confirmed this in its final advice.

314. Regarding the detail of option 2, one investment management association stressed the need to avoid over-prescription on the meaning of the terms 'timely basis' and 'significant cash flow' while highlighting that the depositary should only be required to ensure that procedures are in place to identify inconsistent cash flows but not to make a judgement itself on the inconsistency. The same stakeholder also objected to what it considered to be an overly burdensome provision in paragraph 5 on the basis that it would go beyond the role to be played by the depositary.

45. **ESMA's response:** ESMA felt it appropriate not to prescribe further the notions of 'timely basis' and 'significant cash flows', taking into account the broad range of AIFs covered by the Directive.

<u>Paragraph 1</u>

- There should be recognition of the current market practice that where cash accounts are opened in the name of the AIF with a third party, the global proceeds are credited in the account opened in the custodian's book.

46. **ESMA's response:** ESMA did not consider it appropriate to make reference to such market practices, bearing in mind that the obligations at Level 1 are clear and will be specified further in the implementing measures.

<u>Paragraph 2</u>

- The reference should be to reconciling cash **<u>balances</u>**.
- The proper procedures should be **<u>at the AIFM</u>**.

47. **ESMA's response:** ESMA did not agree with the proposal to limit the reconciliation to cash balances and felt that the original wording was more in line with Article 21(7) of the Directive. ESMA did not wish to specify at which entity the procedures should be in place, as this will depend on the precise operational set-up; the key requirement is that there be procedures in place.

<u>Paragraph 4</u>

- The depositary should check that the relevant cash accounts opened in the name of the AIF are included in the reconciliation process.

48. **ESMA's response:** ESMA saw merit in clarifying that the relevant cash accounts opened in the name of the AIF should be included in the reconciliation process and has made a corresponding change in the final advice.

Paragraph 5

- Clarify by adding a reference to '**any discrepancies identified by the reconciliation** procedures'.

49. **ESMA's response:** ESMA agreed with this clarification and has introduced amended text in the final advice.

Q.25 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?

315. A large majority of respondents expressed their disagreement with any requirement for the general operating account and the subscription/redemption account to be opened at the depositary pursuant to Article 21(3) and many questioned the compatibility with Level 1 of such a provision. Many respondents felt that such a requirement was not in line with current market practice (e.g. for real estate funds), while two depositary associations believed it would be detrimental to the AIF and ultimately investors due to the adverse impact on distribution channels and increased costs.

50. **ESMA's response:** Taking into account the general disagreement among respondents and the arguments put forward, ESMA has not included such a requirement in the final advice.

Box 77 (Ensuring the AIF's cash is properly booked)[45]

316. Several respondents supported the requirements of Box 77. Other respondents made the following specific comments.

Paragraph 1

- Delete 'or belonging to the third party' on the basis that it is not possible in practice to book the AIF's cash separately from cash accounts belonging to the third party. The association that made this comment explained that, where cash is booked with a third party as a deposit, the third party

[45] This has been merged with the previous box in the final advice.

accepts that cash as 'banker' with the result that the cash would not be considered to be distinct from cash belonging to it; rather the AIF would only hold a claim as a creditor on the third party.

51. **ESMA's response:** In the final advice, these boxes have been merged; during that process, the reference to 'or belonging to the third party' has been deleted.

Paragraph 2

- Insert after the word 'ensure' the words 'that the AIF or AIFM has appropriate procedures in place to ensure that'.
- Delete the references to 'compelled' and 'investment decision', replace with concept of 'interests of the AIF' on the basis that the proposed wording place inappropriate restrictions on the opening of accounts outside the EU (Article 21(7) refers to 'in the relevant market where cash accounts are required') and there should be recognition that cash accounts may be opened for other purposes such as to facilitate distribution.

52. **ESMA's response:** On the first point, ESMA did not consider it appropriate to limit the obligation in this way taking into account the clear wording of Article 21(7). On the second point, ESMA agreed with the concerns raised and decided to introduce amended wording in the box so as to ensure consistency with the Level 1 text.

317. One private equity association felt that reference to compliance with Article 16 of the MiFID Level 2 Directive should be deleted as it was unnecessary given the specific obligations imposed by the AIFMD; the same respondent called for the provisions of Article 21(3)(c), permitting non-bank entities to act as depositary, to be reflected in the advice as this was particularly important for PE and VC funds.

53. **ESMA's response:** The final advice now refers only to Article 18 of the MiFID Level 2 Directive. For the purposes of cash flows and booking of cash, any entity at which cash accounts are opened that is not covered by that article must be 'of the same nature' as such an entity in accordance with Article 21(7). Article 21(3)(c) is not relevant in this context.

Q.26 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?

318. Many respondents provided helpful information with respect to the frequency of the reconciliation of cash flows, while stressing that it was difficult to generalise due to the diversity of AIFs.

54. **ESMA's response:** ESMA thanks respondents for the feedback provided on this point, which gave a clearer picture of current market practice.

Q.27 Are there any practical problems with the requirement to refer to Article 18 of MiFID?

319. The majority of respondents did not anticipate any practical problems.

55. **ESMA's response:** Taking into account respondents' views, the reference to Article 18 has been retained in the final advice.

Q.28 Does the advice present any particular difficulty regarding accounts opened at prime brokers?

320. Most respondents foresaw no particular difficulties provided option 2 in Box 76 was adopted. In this context, several investment management and depositary associations noted that the depositary would be relying on the prime broker or AIFM to provide sufficient documentation to demonstrate that the requirements of paragraph 2 in Box 77 had been satisfied. Two depositary associations went further, arguing that the AIFM should be held liable for the negligence of the prime broker when the latter does not provide all information to the depositary on a timely basis and that the AIFM should be obliged to require the prime broker to transmit all information to the depositary in order to allow it to carry out its duties.

56. **ESMA's response:** In light of the feedback provided, ESMA did not make specific changes with regard to prime brokers in the context of cash monitoring. However, taking into account respondents' concerns regarding the provision of adequate information, ESMA has introduced in Box 82 additional requirements in relation to the information to be provided to depositaries by prime brokers.

Q.30 What would be the estimated costs related to the implementation of option 1 or option 2 of Box 76?

Q.31 What would be the estimated costs related to the implementation of cash mirroring as required under option 1 of Box 76?

321. Most respondents were not able to quantify the costs given e.g. the diverse nature of AIFMs/AIFs, but stressed that option 1 would lead to significantly higher costs due to such factors as the increased number of staff needed. One investment management association estimated the increase in running costs to be between 30-100% (on top of additional costs for building new systems), while one private equity association estimated an increase of 5-10 basis points for basic services and up to 20 basis points if the depositary provides other services.

322. Many stakeholders were not able to quantify the costs but expected significant additional investment in technology, duplication of part of the middle office and valuation functions, fundamental changes in the interactions between the depositary and the fund manager and ongoing support from various teams in order to ensure the provision of adequate data on a timely basis. One respondent gave the example of the significant cash flows accruing to a real estate fund through monthly rents, which in their view would prove very costly to mirror with little benefit in terms of investor protection.

57. **ESMA's response:** As set out above, ESMA selected option 2 in its final advice based in part on the feedback in relation to the costs associated with option 1.

2. 1 Definition of financial instruments that should be held in custody

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

Q.32 Do you prefer option 1 or option 2 in Box 78? Please provide reasons for your view.

323. There was general support among respondents for the proposed treatment of transferable securities, money market instruments and units of CIUs. However, views were split on the options proposed. Some respondents felt that both options inappropriately narrowed the scope of the depositary's duties as set out at Level 1. These respondents were of the view that the custody status of an instrument should not be linked to the possibility of its transfer via a settlement system (due in particular to the absence of central depositaries in many non-EU markets). The same stakeholders were also against option 1 as their interpretation was that any appointment of a sub-custodian would bring the assets outside the scope of option 1 (which would be counterintuitive as the sub-custodian is appointed precisely to carry out custody of the assets). There was also concern that option 1 left depositaries too much flexibility to structure the manner in which the assets are held so as to circumvent the provisions of the Directive. For some of these respondents, the decisive criterion should be the substantive power of disposal or claim vested with the depositary in respect of the registered account or held assets, while for others the depositary should be responsible for all financial instruments held in its custody network, with 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'.

324. There was significant support for option 2 for a number of reasons. One investment management association felt that option 1 was unclear and could lead to the inclusion of certain instruments that should be excluded e.g. partnership interests or real estate assets. Another stakeholder supported option 2 as they felt it did not fetter the ability of the AIF to use the financial instruments in whichever way it deems appropriate in the operation of its business, whether to use those assets as margin or security or having to re-register them in the name of the AIF. One banking association, meanwhile, supported option 2 on the basis that the depositary may be unable to verify the existence and location of assets and to retrieve them at any given time through the application of effective operational processes and controls. A real estate association favoured option 2 on the basis that option 1 was unclear, particularly for RE assets; in its view there should be no requirement for assets be registered in an account in the name of the depositary or the depositary's nominee in order for them to be subject to custody requirements.

325. Two banking associations supported option 2 subject to amendments, notably in paragraph 1 the addition of a reference to the depositary or sub-custodian being the registered holder of the financial instruments and in paragraph 3 the addition of references to regulated central reconciliation procedures and a list of similar non-EU securities settlement systems that would be drawn up by ESMA. Another depositary association supported option 2 provided that it was understood that the financial instruments are held in custody by the depositary within its sub-custody network.

58. **ESMA's response:** ESMA has considered carefully the views expressed by respondents in relation to the financial instruments to be held in custody. The approach taken in the final advice aims to reflect the broad scope of assets covered by Article 21(8)(a), namely 'all financial instruments that can be registered in a financial instruments account opened in the depositary's books' as well as 'all financial instruments that can be physically delivered to the depositary'. As set out in Article 4(1)(n) of the Directive, 'financial instruments' is to be understood as those instruments specified in Section C of Annex I of Directive 2004/39/EC. In the light of the aforementioned provisions, the scope for exempting particular financial instruments seems limited. Regarding the two options identified, ESMA acknowledged concerns highlighted by some respondents about the potential uncertainties raised by option 2, and in particular the concept of 'similar non-European settlement systems'. On balance, ESMA considered that the reference to instruments registered or held in an account directly or indirectly in the name of the depositary provided greater clarity and was more consistent with the Level 1 provisions. ESMA has also clarified that transferable securities that embed derivatives should be covered.

326. One investment management association felt that the depositary should be under an obligation to inform the AIF/AIFM of any assets belonging to the AIF for which it does not assume the custody function.

59. **ESMA's response:** The written agreement appointing the depositary should contain information on the assets that will be subject to the depositary's safekeeping and oversight duties, including which assets will fall in custody.

327. Several respondents commented on the approach taken with regard to instruments that can be physically delivered. One proposal was that instruments that can be physically delivered to the depositary should be held in custody provided that title can be transferred by such physical delivery. On a similar point, another stakeholder favoured referring to financial instruments which are (instead of 'can be') physically delivered in order to avoid giving an incentive to use physical certificates when dematerialisation is possible, while one respondent favoured a reference to financial instruments which have been physically delivered

60. **ESMA's response:** ESMA considered it appropriate not to diverge from the wording of Article 21(8)(a) in this context.

328. One association sought clarification on the text in Box 78 relating to the re-use of assets; in their view once a right to re-use has been given and exercised, this will typically involve a full title transfer of securities resulting in a change of ownership.

61. **ESMA's response:** ESMA has clarified the approach to re-use of assets in the explanatory text i.e. when the right of re-use has been exercised, the depositary will still be liable to return the asset in the case of loss.

329. One association welcomed the non-exhaustive list of 'other assets' in paragraph 29 of the explanatory text but made three comments:

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

– cash (whether or not booked with a third party) is subject to the provisions of Article 21(7), not Article 21(8)(b) and therefore the distinction between custody assets and 'other assets' is not relevant in this context;

– an additional bullet point should make it clear that investments in privately held companies and interests in partnerships or collective investment undertakings not traded on a regulated market are 'other assets' (c.f. paragraph 26 of Explanatory text).

62. **ESMA's response:** On the first point, ESMA has chosen option 2 in the final advice (see further details below). On the second point, ESMA is of the view that cash should be treated as an 'other asset' and that it does not only fall under Article 21(7). Indeed, ESMA considers it contrary to the spirit of the Directive to afford lesser protection to the cash of the AIF than to other assets held in custody or subject to record keeping. As far as the final point is concerned, ESMA is of the view that the definition in the box of financial instruments to be held in custody, taken together with the illustrative list of 'other assets' in the explanatory text, provides sufficient clarity on the distinction to be drawn between the different categories of asset.

Q.33 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?

330. Respondents provided useful information on the kind of financial instrument currently held in custody. Two banking associations identified transferable securities, money market instruments and units of CIUs, while one explained in detail the various approach taken to custody in the EU and US (rights in rem in securities, approaches in civil law jurisdictions, determination of legal transfer by CSDs in certain jurisdictions).

331. One association explained that in the UK, FSA-authorised investment managers held in their own custody (or through their nominee) the shares in companies, or units in unit trusts belonging to the real estate fund, which companies or trusts invest in turn in land and buildings.

332. One banking association explained that depositaries generally accepted assets for safekeeping if they could collect information on and income from such assets (dividends in the case of stocks/equities and coupons (interest payments) in the case of bonds) and administer related tax withholding documents and foreign tax reclamation, administer voluntary and involuntary corporate actions, provide information on the securities and their issuers such as annual general meetings and related proxies.

333. One settlement system explained that in all EU MS, almost all securities were kept in book-entry form in securities accounts even if the underlying securities are held in physical form.

334. One stakeholder explained that the current market practice was to view assets held in custody much more broadly then proposed under options 1 and 2 in Box 78.

335. Finally, one private equity association noted that PE/VC funds typically did not use custodians because of the nature of the assets held.

63. **ESMA's response:** ESMA is grateful for the input provided by stakeholders on this point, which proved helpful in determining the final position set out in the advice. Nevertheless, ESMA stresses that the intention of the Directive and the accompanying implementing measures is not necessarily to maintain current market practice and that this is only one element to be taken into account in drafting the legislative provisions.

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

336. Two banking associations supported option 2 on the basis that it provided the necessary flexibility.

337. There was significant support for option 3 on the basis that it had the widest scope, was the clearest of the options and avoided the need for the depositary to analyse the legal effect of each individual collateral arrangement.

338. Although there was support for the use of cross-references to the Financial Collateral Directive (FCD), several associations suggested widening the scope of option 3 to cover collateral arrangements which are not financial collateral arrangements under the Financial Collateral Directive in order to allow greater certainty over equivalent arrangements existing outside the EU. One of these respondents was also concerned that both options 2 and 3 could be interpreted so broadly as to include all types of possessory security interest available under common law or otherwise (e.g. custodial liens or liens arising via a settlement system or CSD), which could potentially lead to all assets held in dematerialised form being considered as collateral; in order to address this, the respondent suggested qualifying the exemption by referring only to financial collateral arrangements entered into by the AIF and/or the depositary with prime brokers and counterparties, or to exclude from the exemption financial collateral arrangements entered into by the AIF and/or the depositary with persons providing safekeeping-only services.

339. Two respondents noted that the draft advice did not deal explicitly with collateral received by the depositary or any sub-custodians for the benefit of the AIF and that such collateral should be regarded as having been 'entrusted to the depositary for safekeeping' within the meaning of Article 21(8).

340. One respondent felt that all collateral arrangements (not just those subject to the FCD) should be covered by the depositary's general oversight responsibilities as regards the adequacy of the arrangements put in place by the AIFM e.g. reviewing the selection, appointment and ongoing use of the counterparty by the AIFM, the level of the haircut and the enforceability of the agreements.

64. **ESMA's response:** The treatment of collateral is a key part of the definition of financial instruments to be held in custody; as such, the relevant provisions have been merged into a single box in the final advice (Box 79). Although there was a lot of support for option 3 as set out in ESMA's draft advice, views were mixed and option 2 was considered by some as a good compromise. Taking into account the clear requirements of the Directive with regard to financial instruments that should be held in custody, ESMA took the view that option 2

represented the most appropriate balance between recognition of current market practice and protection of the AIF’s assets. On the other points raised above, ESMA has clarified that collateral received by the depositary or sub-custodian for the benefit of the AIF should be held in custody. Finally, ESMA has clarified that only collateral arrangements within the meaning of the Financial Collateral Directive (or equivalent such arrangements in non-EU jurisdictions, where applicable) should be taken into account for the purposes of determining whether financial instruments provided as collateral should be held in custody. This was done with the aim of having a harmonised approach across the EU, which could have been undermined had any possible collateral arrangement been excluded from the scope of custody, and taking into account the need to have regard to existing parts of the acquis.

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

341. Respondents expressed mixed views on this point. For some, it was not easy in practice to differentiate between a ‘title transfer collateral arrangement’ and a ‘security financial collateral arrangement’ as the agreement setting out the collateral arrangement was often very complex and would require an in-depth legal analysis to determine to which category the collateral arrangement belonged. In contrast, one depositary association saw no need for further clarification, while other respondents explained that the distinction should normally be clear on the basis of the documentation. One association explained that global custodians and prime brokers already had procedures to identify whether collateral provided is by title transfer or security transfer, and that the Securities Law Directive provided a clear mechanism for identifying where a third party creditor has an interest in the financial instruments used as collateral.

65. **ESMA’s response:** ESMA is of the view that parties to collateral agreements should be in a position to identify the type of collateral arrangement involved; indeed, this would appear to be a crucial element of the transaction.

2.2 Conditions applicable to the depositary when performing its safekeeping duties on each category of assets

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

342. Several respondents agreed with the general principles and the description of the safekeeping duties. One association stressed the need to minimise duplication with services provided by other service providers (e.g. valuers) to avoid inefficiencies and unnecessary costs.

343. The following specific comments were made.

<u>Paragraph 1(a)</u>

- The wording ‘on its books’ should be added in order to make clear that the requirement relates to segregation at the level of the depositary’s own books and records only.

- ‘registered’ should be replaced with ‘recorded/booked’.

- Unless all assets subject to a security arrangement or right of re-use are excluded entirely from the definition of custody assets (rather than only where that right has been exercised), it would not be possible to completely segregate the assets as proposed e.g. where the assets are held in custody with an agent bank or clearing house, they are generally held in the name of the financial institution rather than in the names of the underlying AIFs.

66. **ESMA’s response:** ESMA agreed with the need to clarify that the segregation requirement applies at the level of the depositary’s own books and records. However, ESMA preferred to retain the word ‘registered’ for the sake of consistency with the Level 1 text. On the final point, ESMA has set out its approach to the treatment of collateral in Box 79. As noted elsewhere, the requirements set out in the advice may require changes in market practice in the interests of ensuring greater protection of the AIF’s assets.

Paragraph 1(b)

- The standard of care is too high and should be replaced by ‘the due care that would reasonably be expected of a professional custodian...’. The text represents a vague and potentially very high level of obligation without any real legal or regulatory precedent or established standard against which it could be judged.

67. **ESMA’s response:** ESMA considers the standard of care proposed in the draft advice to be appropriate, taking into account in particular the objectives of the Directive. Given the approach on liability for loss of assets, it is reasonable to require the depositary to apply a high level of care to the assets held in custody (and indeed it will be in the depositary’s own interests to do so). A more detailed explanation of what would be required from the depositary is set out in the explanatory text.

Paragraph 1(c)

- The proposal goes significantly beyond what a depositary could reasonably be expected to assess, particularly as regards custody risks related to settlement systems.

- There should be some limitation on the liability of the depositary in circumstances where it has identified potential risks in a custody or settlement-related situation.

- The specific reference to ‘custody risks related to settlement systems’ is unnecessary on the basis that settlement systems normally deal with the delivery of securities against payment and it is thus the safekeeping of the securities that should be the focus of the custody risk assessment.

– The disclosure requirement should relate to the entire assessment and monitoring process and not be limited to ‘the custody risks related to settlement systems’, and should apply to the entire custody chain (c.f. paragraph 2 of Box 80).

68. **ESMA’s response:** ESMA agrees that the text as originally drafted could have introduced uncertainty regarding the depositary’s duties in relation to settlement systems. The text has therefore been clarified to refer to ‘all relevant custody risks’. ESMA has also clarified that the assessment relates to the entire custody chain. Concerning liability, ESMA has set out the interaction between the depositary’s risk-assessment role and the liability framework in the relevant part of the advice.

344. One investment management association requested that paragraph 2 be modified so as to clarify that the depositary is obliged to impose on the sub-custodian that any further delegation will also be on the basis of the segregation requirements set out in Box 89. Two stakeholders, including a representative of institutional investors, favoured elaborating on the concept of ‘due care’ in 1(b) in order to oblige the depositary to:

- know which custodians constitute the custody chain;
- understand the relevant risks that exist at each level of the chain;
- ensure that the due-diligence and segregation obligations have been imposed throughout the chain (from delegate to delegate) at a contractual level;
- ensure that it has appropriate right of access to the books and records of the sub-custodian as well as any of its delegates to ensure compliance with these requirements; and
- document all of the above, make these documents available and report to the AIFM.

69. **ESMA’s response:** ESMA agrees that the segregation obligation must apply throughout the custody chain. ESMA also agreed with the desirability of clarifying the obligation of ‘due care’ and has elaborated on this in the explanatory text.

345. A settlement system was of the view that, should ESMA oblige the depositary to carry out a specific assessment of the CSD, this assessment should rely on the regulatory assessment, disclosures and transparency measures already required under ESCB/CESR and CPSS/IOSCO standards applicable to CSDs.

70. **ESMA’s response:** in the final advice, the specific reference to assessment of settlement systems has been removed; as such, the obligation on the depositary is to carry out an assessment of all relevant custody risks throughout the custody chain and inform the AIFM of any material risk identified.

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

346. A large majority of respondents expressed a clear preference for option 1 for a number of reasons, including that:

- option 2 would impose significant additional costs without increasing investor protection;
- option 1 was more in line with current market practice;
- option 2 imposed unreasonable obligations on a record keeping function;
- option 2 would involve duplication of part of the clearer or prime broker activity;
- option 1 was the only pragmatic choice;
- a requirement to provide information ex ante to the depositary could hamper the ability of the AIF to transact in its assets.

347. One private equity association considered option 1(ii) as the most practical; they felt option 1(i) was inappropriate as it implied ex-ante controls while option 2 was seen as costly and impractical.

71. **ESMA's response:** Taking into account the broad support from respondents, ESMA's final advice is based on option 1.

348. Several investment management associations agreed with the merits of having documentary evidence upon every acquisition or sale of a significant asset but called for proportionality e.g. it should not be required for ancillary assets in a real estate fund. Some stakeholders noted that it was not common practice to renew legal real estate title or corporate certification on an annual basis and that it would be preferable to take a risk-based approach to documentation focusing on significant transactions. One real estate association made a general request for flexibility in the requirements on verification of ownership of real estate assets.

72. **ESMA's response:** As the Level 1 text makes no distinction between 'significant' and 'ancillary' assets, ESMA does not consider it appropriate to introduce one in its advice. Any such distinction would also be likely to lack clarity and lead to uncertainty over which assets should be covered. ESMA has therefore confirmed its approach, which requires the depositary to have a comprehensive overview of the AIF's assets at all times.

349. One private equity association suggested deletion of the reference to 'corporate action' on the basis that this covered dividends; if a corporate action resulted in the issue of more assets then these would be acquired, which was already covered by the text.

73. **ESMA's response:** ESMA has clarified that the obligation relates to corporate actions resulting in the issue of more assets.

350. Regarding the last sub-paragraph of paragraph 3, one private equity association was of the view that the AIFM should have sole discretion to determine whether legal action is needed. The same respondent felt that paragraph 39 of the explanatory text was redundant because Article 21 covered all assets regardless of the use of a particular legal structure. The respondent went on to object strongly to paragraph 43 on the basis that the provision of prior information to the depositary would interfere with the current market practice for PE/VC funds e.g. deals subject to last-minute changes, tight deadlines set by third parties, competition among rival bidders etc.

74. **ESMA's response:** As set out above, option 2 has not been retained with respect to financial instruments to be held in custody. The additional text foreseen in Box 81 of the CP has

therefore been deleted. With respect to provision of prior information, this should not be confused with the concept of ex-ante approval. ESMA has made it clear elsewhere in the advice that ex-ante approval should only be required where both the depositary and the AIFM agree on such an approach.

351. One association sought guidance on the information the depositary would be expected to obtain to satisfy itself of ownership and whether this would vary by asset class or by type of institution holding the asset. The respondent suggested it should be possible for the depositary to rely on client statements or other reports provided by authorised financial institutions as evidence of the ownership right of the AIF, and that where assets are held in physical custody (e.g. commodities) the depositary should similarly be permitted to rely on ownership information provided by the relevant custodian of those assets.

75. **ESMA response:** ESMA had already acknowledged in the explanatory text of Box 81 that the depositary may rely on formal and reliable evidence where it considers it appropriate. ESMA has clarified in the final advice that such evidence may be provided by a range of entities.

352. One institutional investor called for the status of cash to be properly analysed and resolved. In its view, cash fell into two broad categories. The simpler scenario involved cash placed with a third party as a result of an investment decision by the AIFM; in that case the AIFM was responsible for selection of the third party and adherence to certain operational standards (Articles 16(1)(e), 16(3) and 18 of MiFID L2) and the depositary should oversee the actions of the AIFM. The second scenario involved uninvested cash, which may be placed with the depositary or, if the depositary does not have the relevant licences or operational capability, the depositary may take the decision to place the cash with a third party. In the former case, the respondent was of the view that the general record-keeping requirements of Article 16 of MiFID L2 applied to the depositary; in the latter case the requirements of Box 89 applied directly to the depositary.

76. **ESMA's response:** ESMA is of the view that the depositary's duties with respect to cash should not be limited to those under Article 21(7) and that cash should fall under the heading of 'other assets'. ESMA recognises, however, that it may not be feasible to apply all of the safekeeping duties to cash in the same way as for other assets. ESMA has clarified in the explanatory text that these duties are to be applied to cash 'to the extent possible', but as a minimum that the depositary should at least maintain a record of the cash belonging to the AIF, check the consistency between the positions in its records with those of the AIFM and set up and implement an escalation process for situations where an anomaly is detected.

Q.35 How do you see the delegation of safekeeping duties other than custody tasks operating in practice?

353. One private equity association saw these duties as being in the nature of record keeping and monitoring only.

354. Two depositary associations envisaged few delegation scenarios for safekeeping duties other than custody tasks, with the exception of prime brokers. One of the associations also stressed the

need to rely on third parties in many cases in ensuring the depositary has timely access to record etc.

355. One real estate association envisaged the need for depositaries of RE funds to rely on (and contract directly with) a number of third parties such as notaries, lawyers, property managers, title insurers etc.

356. One depositary representative stressed that the depositary would not always appoint a third party who has control and maintains day-to-day records of the underlying asset e.g. where the third party is a delegate or affiliate of the AIFM; in such cases it was the responsibility of the AIFM to ensure that the depositary has appropriate and timely access to records and documentary evidence.

357. Another stakeholder explained that delegation of this part of safekeeping (i.e. delegation of prime brokerage intervention or of record-keeping duties to be performed by the prime broker) was difficult to operate in practice.

77. **ESMA's response:** No changes to the advice were made as a result of the points raised by respondents but ESMA is grateful for the feedback received, which helped clarify the way in which safekeeping of other assets will be done in practice.

Q.36 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?

358. One investment management association saw no significant difference in terms of control and considered that the key control was focused on the parties than can instruct the movement of the assets and/or has the right to claim the assets.

359. Two other respondents saw a difference in that under case (i), the assets could be transferred without the involvement of the depositary which would not be possible (in the absence of fraud) in cases (ii) and (iii).

360. One private equity association considered this notion to be irrelevant to PE/VC funds due to the unique nature of the investments and the existence of transfer restrictions.

361. Two associations explained that in case (i), the depositary must rely on its contract with the AIF to receive the necessary information (this was common market practice for RE and PE funds); in case (ii), the depositary controls the execution of the investment and specific the mailing address and bank accounts that must be used in relation to the assets; while in case (iii), typically involving larger volumes of transactions made on behalf of a number of clients, the operation of an omnibus registration by the depositary provides control and segregation from proprietary assets while offering greater efficiency and automation. Several respondents favoured an approach which would allow all three models to continue.

362. One banking association explained the distinction as follows:

(i) When the assets are directly registered in the name of the AIF, the depositary should be provided by the AIF with an unquestionable document with regards to the acquisition/sale. There is no relationship between the depositary and the issuer. A functional relationship, however, may be set up between the depositary and the issuer, whereby the depositary can be granted exclusive authority to give instructions on the account opened in the name of the AIF (or the AIFM).

(ii) When the assets are registered in the name of the depositary on behalf of the AIF (i.e. in the form of depositary/AIF or depositary /AIFM), the depositary reconciles its positions with the transfer agents.

(iii) When the assets are registered in the name of the depositary on behalf of a group of unidentified clients (omnibus account), the above processes apply.

363. One investment management association considered that the key principle was the extent to which the asset could be transferred without referral to, and verification by, the depositary rather than the manner of registration.

364. A depositary association stressed that registering in a nominee name did not in itself suggest the asset is held in custody.

78. **ESMA's response:** ESMA has clarified in the final advice that financial instruments that are directly registered with the issuer itself or its agent in the name of the AIF should not be held in custody unless the instrument is registered or held in an account directly or indirectly in the name of the depositary. This approach takes into account the fact that the depositary is less able to exercise control over the instrument where that instrument is registered directly with the issuer in the name of the AIF, while recognising the specificities that exist in some Member States (such as registered shares in Germany).

Q.37 To what extent would it be possible / desirable to require prime brokers to provide daily reports as requested under the current FSA rules?

365. A majority of investment management, depositary and prime broker representatives considered it both desirable and feasible for to require daily reporting by prime brokers on the status of their client assets and client money. One investment management association felt this information should be available online for depositaries to access as required. Two depositary associations highlighted information on monitoring of re-hypothecation, segregation and mark-to-market of the assets as being particularly relevant. One prime broker representative, meanwhile, highlighted that the UK rules required the reports to be provided ex post (T+1 minimum) and that any such requirement would have to impose an obligation on the depositary to ensure such reports are made available. One stakeholder felt this would foster a level playing field between prime brokers and depositaries in relation to information on re-use of assets taking into account the requirement in paragraph 8 of Box 74 of the CP.

366. One investment management association considered this issue to be outside the scope of the Commission's request and that any initiative to impose UK FSA-type rules more widely would require a more detailed consultation.

367. Associations of PE/VC funds, RE funds and non-tradeable closed-end funds considered this irrelevant for their sectors.

368. One banking association saw the role and responsibilities of the prime broker as follows:

i) They should not be considered as prime custodians of the AIF;

ii) They should not be viewed as a sub-custodian to the depositary when holding assets as collateral but instead they should be required to accept liability on the collateral portion;

iii) They should be required to provide relevant statements of transactions or, binding statements of holdings to enable the depositary to perform its oversight and record keeping function so as to have a full overview of the assets and the cash movements of the AIF;

iv) They should be required to provide a daily update (including re-used assets);

v) Assets of the fund with the PB should be clearly identified and segregated;

vi) Direct access to reporting lines should be available to the depositary.

79. **ESMA's response:** In light of the strong support from broad range of stakeholders for the introduction of specific reporting obligations on prime brokers, ESMA has incorporated this into the final advice. ESMA considers that it had sufficiently detailed feedback on the content of the obligations to allow it include such requirements in the advice and is satisfied that this is in line with the request for assistance received from the European Commission.

Q.38 What would be the estimated costs related to the implementation of option 1 or op-tion 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 record?

369. Most respondents were not able to quantify the costs but considered it safe to assume that option 2 would be considerably more expensive due to e.g. additional personnel and IT systems.

370. One association felt that option 2 might involve lower costs as it involved fewer requirements on the depositary but was not able to state this conclusively.

371. One stakeholder noted that the costs depended on the details of the requirement e.g. a requirement for near-real time record-keeping would involve significant costs.

80. **ESMA's response:** As set out above, ESMA's final advice is based on option 1. This choice was based partly on the feedback provided by respondents on the cost impact of the different options.

Q.39 To what extent does / should the depositary look at underlying assets to verify ownership over the assets?

372. One investment management association supported requiring a look-through approach by depositaries but felt this should be applied in a proportionate way e.g. by allowing for reliance on

appropriate documentary evidence, legal opinions as well as on accredited local auditors (particularly where this is substantial use of intermediary entities e.g. AIFs investing in real estate through an SPV). Similarly, one real estate association stressed that depositaries should be allowed to inspect documents themselves but also to rely on external reports from lawyers, notaries etc.

373. Several stakeholders were against a look-through approach in the context of e.g. the assets underlying a CIU. If the question related more to the level of due diligence a depositary should carry out to verify ownership of non-custody assets held directly by the AIF, several respondents were against any prescriptive approach due to the wide diversity of assets covered.

374. One private equity association was strongly against a look-through approach on the basis that this would be impractical and duplicative and felt that the depositary's obligations should be confined to those assets held directly by the AIF.

375. One depositary association was against a look-through approach unless ESMA could provide further guidance on exactly in which circumstances it would be required.

376. One representative of the real estate sector was against a look-through approach except in very limited circumstances (such as in order to discharge its obligation to have oversight of the valuation process under Article 21(9)(b)) and sought confirmation that such a look-through should not include verification of ownership of the underlying (on the basis that for RE funds this would lead to unnecessary and expensive duplication of e.g. verification of title to land and buildings).

377. Another representative of the real estate industry felt that depositaries should look at underlying assets but in different ways depending on how the assets are held (for subsidiary companies it would be sufficient to verify share certifications/registers of SPVs while for direct property ownership there should be verification of title to real estate). More generally, the respondent considered it desirable to rely on contractual controls between the AIF, the AIFM and the depositary.

378. One depositary association believed that the depositary should ensure that the AIF has robust procedures to confirm that assets not held at the depositary are verified by the AIF and reconciled by the administrator.

379. One institutional investor representative supported a look-through approach to the underlying assets of an SPV.

81. **ESMA's response:** ESMA has made it clear in the final advice (see paragraph 5 of Box 81) that a look-through approach should be taken to assets held by financial and/or legal structures controlled directly or indirectly by the AIF or the AIFM on behalf of the AIF. This requirement is aimed at preventing possible circumvention of the requirements of the Directive by recourse to SPVs. Taking into account feedback to the consultation, ESMA has specified that in carrying out its safekeeping duties in this context, depositaries may rely on legal opinions and appropriate documentary evidence in order to verify ownership.

3 Depositary functions pursuant to §9 – Oversight duties

Box 82 (Oversight duties – general requirements)

380. The majority of respondents expressed broad support for the requirements and welcomed the focus on ex-post controls and verification of processes and procedures.

381. One investment management association supported, in the interests of efficiency, allowing the use of existing audit, compliance or other materials already produced by the AIF/AIFM for other purposes. The same respondent also sought further clarification on what was meant by ‘obligations pursuant to Article 21(9)’.

382. One private equity association suggested wording aimed at limiting the verification duty to those areas under the depositary’s responsibility. The same respondent raised strong concerns regarding the reference to ex-ante controls in paragraph 49 of the explanatory text; in their view where this was the current practice, this should be deemed to satisfy the ex-post verification duties set out in the Directive.

383. Two stakeholders felt that the depositary should not be required to assess the risks associated with the AIFM and considered that this went beyond the L1 text. For one, such a requirement also undermined the AIFM’s own fiduciary and regulatory duties on the basis that the AIFM is responsible for establishing its procedures and ensuring compliance with the Directive. Similarly, one prime broker representative argued that oversight should not extend to the risk management of the fund on the basis that this was one of the non-delegable duties of the AIFM. Two other respondents also favoured an explicit statement that the precise details of the depositary’s role would depend on the nature, scale and complexity of the AIF/AIFM.

384. One depositary association was of the view that the proposals went well beyond the scope of Article 21. Another felt the provisions should not imply that it is for the depositary to ensure compliance by the AIFM with the Article 20 requirements on delegation.

82. **ESMA’s response:** Taking into account the broad support from respondents, the requirements set out for consultation are largely unchanged in the final advice. ESMA has also clarified that the requirements are without prejudice to the responsibilities of the AIFM under Article 20.

Box 83 (Oversight duties related to subscriptions/redemptions (a))

385. Many respondents agreed with the proposed advice.

386. One investment management association felt that the depositary should not be required systematically to police the AIF/AIFM's operations and that it should be able to base its actions on information provided by the administrator under contractual arrangements. Similarly, one prime broker representative was of the view that the depositary should only be required to oversee ex post any administrator to which verification of subscriptions and redemptions have been delegated rather than carrying out the verification itself.

387. Private equity representatives proposed adding references to open-ended funds in both points in order to exclude PE/VC funds, for which they considered such obligations to be irrelevant.

388. With respect to the final sub-paragraph, one depositary association felt that the frequency of the depositary's checks should be proportionate to the frequency of subscriptions and redemptions while another favoured determining the frequency of the checks based on the nature, scale and complexity of the AIF and frequency of the calculation of the units or shares.

83. **ESMA's response:** ESMA believes that the advice published in July set out clear requirements on the depositary with regard to oversight of subscriptions and redemptions, including the extent to which the depositary should carry out tasks itself or be able to rely on a separate entity. Regarding the requests to refer only to open-ended funds, ESMA has noted that the Level 1 text makes no distinction of this kind. The advice does make clear, however, that the frequency of the depositary's checks should be proportionate to the frequency of subscriptions and redemptions.

Q.43 Regarding the requirement set out in §2 of Box 83 corresponding to Article 21 (9) (a) and the assumption that the requirement may extend beyond the sales of units or shares by the AIF or the AIFM, how could industry practitioners meet that obligation?

389. A large majority of respondents felt it would be practically impossible for the depositary to fulfil such an obligation if it extended to sales in the secondary market and that it should be limited to the verification of information stemming from the AIF's register.

390. One real estate association felt this could only be met in practice by requiring investors to declare their eligibility at the time of the initial investment and ensuring that the AIF's rules or instruments of incorporation require that the eligibility requirements be met on entry and transferred between investors on any subsequent transfer. One banking association felt the obligations could be met at a higher cost if the depositary received access to the relevant information and records of the AIF/AIFM or a third party provider, and if the L2 measures specified that:

- a third party is also obliged to provide the information and records to the depositary;
- the AIF (or the AIFM acting on behalf of the AIF) has to provide independent audit reports about his control/risk environment (e.g. SAS70-reports or equivalent); and
- the AIF (or the AIFM acting on behalf of the AIF) and the third party have to allow on-site visits of the depositary/internal audit function for verification purposes.

84. **ESMA's response:** In light of the strong support from the majority of respondents for the approach set out in the draft advice, ESMA has confirmed this approach in the final advice.

Box 84 (Oversight duties related to the valuation of shares or units of the AIF (b))

391. Many respondents felt that the proposals went beyond the scope of Article 21(9)(b) and that they should be limited to valuation of the units or shares of the AIF. As such, the depositary

should not be required to directly oversee the valuation of assets or to check that an external valuer has been appointed (the latter being the AIFM's responsibility). Several respondents favoured deletion of paragraphs 1 and 5 and modification of paragraphs 2 and 3 so as to refer to the calculation of the value of units or shares of the AIF.

85. **ESMA's response:** ESMA has carefully considered the points raised by respondents in this context and the suggestions that the depositary's duty should be limited to the valuation of the units or shares. However, ESMA maintains its view that the depositary's duty should include the valuation of the underlying assets. Indeed, in ESMA's view it would be impossible for the depositary to be satisfied that the valuation of the units or shares has been done correctly if it is not satisfied of the reliability of the data on which that calculation is based (i.e. the underlying assets).

Box 85 (Oversight duties relating to the carrying out of the AIFM's instructions (c))

Q.44 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.

392. Several associations (representing the depositary and investment management sectors) considered the proposals appropriate and in line with market practice, subject to an amendment to paragraph 1 so as to refer to applicable national law and regulation. There was also support from private equity representatives.

393. Several associations (in the real estate and non-tradeable closed-end funds sectors) considered the requirements generally appropriate but one was against an obligation on the depositary to ensure the consistency of the AIF's investments with its investment strategy as they felt this would be impossible to meet in most cases for RE funds and could introduce an unacceptable element of subjectivity in the depositary function.

394. Similarly, one prime broker representative was of the view that compliance with investment restrictions and leverage limits should be the primary responsibility of the AIFM. Two other stakeholders shared these concerns and felt that the proposals risked extending the depositary's role into areas which are more properly the duty of the AIFM i.e. ongoing monitoring of investment restrictions and leverage.

395. One association asked for the principle of ex-post verification of legality of an instruction to be included in the Box and was critical of paragraph 63 of the Explanatory text, noting that there was no justification for different treatment of physical assets and financial instruments that cannot be held in custody. A prime broker representative raised a concern on the same paragraph on the basis that it may not be possible to reverse a transaction in all cases and that this would in any case overlap with the direction of the investment activity of the AIF.

396. One banking association stressed that having an effective risk management process remained the responsibility of the AIF/AIFM and that the depositary's duties should consist of assessing the control procedures and environment at the AIF/AIFM on an ex-post basis.

397. One investment management association felt the depositary's obligations should extend to ensuring that suitable procedures exist and are maintained and noted that it was not for the depositary to make a qualitative assessment of individual trades.

398. One depositary association favoured deletion of the reference to 'unusual transactions' in paragraph 62 of the Explanatory text on the basis that it went beyond the L1 text and could lead to confusion as to the correct interpretation, and sought clarification on the first sentence of the same paragraph.

399. Two associations voiced strong concerns on the reference to ex-ante controls in paragraph 63 of the explanatory text, which one (from the private equity sector) saw as being beyond the scope of the L1 and inappropriate for PE/VC funds.

400. Two depositary associations were of the view that paragraph 1 went beyond the L1 text as the latter referred to 'incorporation document' rather than offering documents, which could change without the depositary's knowledge.

401. One prime broker representative sought further guidance on how a depositary should assess whether procedures are 'proportionate to the nature, scale and complexity of the AIF.'

86. **ESMA's response:** The proposals set out for consultation in July are largely unchanged in the final advice. However, ESMA did agree with the suggestion to limit the verification of compliance to applicable national law and regulation. Regarding some of the comments made about the duties in this context being more appropriately the role of the AIFM, ESMA considers that this should not prevent the depositary from having a role of oversight and verification. ESMA is also of the view that such duties flow naturally from the requirements on depositaries more generally.

Box 86 (Duties related to the timely settlement of transactions (d))

Q.45 Do you prefer option 1 or option 2 in Box 86? Please give reasons for your view.

402. A majority of respondents supported option 1 on the basis that, inter alia, the L1 requirement was sufficiently clear, the additional requirements in option 2 would not add value or safety, the depositary should not be required to 'police' receipt of consideration, option 2 was more appropriate for funds investing in frequently-traded instruments and option 1 provided the appropriate level of flexibility.

403. Two associations (for real estate and non-tradeable closed-end funds) supported option 2 but sought further guidance on the meaning of 'usual time limits' in the context of RE funds. Similarly, one real estate representative, which had no strong preference for either option, stressed that for RE funds, there were no 'usual time limits' for transactions in privately-held companies.

404. One settlement system explained that where settlement of securities occurred on a delivery versus payment (DVP) basis, it was not possible for the AIF to have delivered securities or cash

without having received the related cash or securities. The same respondent acknowledged, however, that additional procedures could be necessary for settlement of transactions that did not occur on a DVP basis.

87. **ESMA's response:** Although a majority of respondents supported option 1, many of those stakeholders considered that the provisions under option 2 were broadly in line with existing market practice. Taking this into account, and also bearing in mind that ESMA was specifically requested by the Commission to elaborate on the duty as set out at Level 1, ESMA considered it more appropriate to confirm option 2 in the final advice.

Box 87 (Oversight duties relating to the AIF's income distribution (e))

405. Two investment management associations were of the view that some of the provisions went beyond the Level 1. Regarding paragraphs 1 and 3, one of these respondents felt that the depositary's duty should be to ensure that appropriate procedures were in place. Many respondents also disagreed with the requirement in paragraph 2 that the depositary should ensure an appropriate follow-up of any reserves expressed by the AIF's auditors (some considered this to be the AIFM's responsibility).

406. The following specific comments were made:

Paragraph 1

- Many respondents were of the opinion that the depositary's oversight duties could only be triggered once a decision had been made by the AIFM to distribute. The same comment was raised by some in relation to paragraph 3.

Paragraph 2

- Two depositary associations could only accept such a requirement if the AIF/AIFM was required to provide the depositary with all information on possible reserves expressed on the financial statements. Another depositary representative favoured deletion of the text as they felt that the depositary's role should be limited to responding to relevant matters affecting fund assets or other issues relevant to its duties but should not include a direct responsibility to follow up on financial statements.

Paragraph 3

- One banking association was of the view that this requirement overlapped with the responsibilities of the external auditor and called for clarification on the extent to which oversight could be delegated to auditors.

88. **ESMA's response:** Although respondents raised some concerns about the extent of the depositary's duties in this context, ESMA maintains its view that the depositary's duty

should not be limited to mere verification of procedures. ESMA did recognise, however, the need to clarify that the duties set out in paragraphs 1 and 3 were only triggered once the AIFM had made a decision to distribution. Amendments have been made to the text in order to take this into account. With respect the obligation on the depositary to ensure appropriate measures have been taken where the AIF's auditors have expressed reserves on the annual financial statements, ESMA has clarified that the depositary should be provided with all information on such reserves.

Q.40 To what extent do you expect the advice on oversight will impact the depositary's relationship with funds, managers and their service providers? Is there a need for additional clarity in that regard?

407. Many respondents welcomed the principles-based approach proposed by ESMA.

408. One banking association set out a number of principles they believed should be followed in the application of the oversight duties such as a focus on secondary-level controls, an ex-post approach, no specification of the means of controls, proportionality and alignment with UCITS. The same respondent also favoured adding a reference to some specific pieces of information the depositary should be provided on commencement of its duties (e.g. risk management procedures, detail on the reserves expressed by the AIF's auditor etc).

409. One depositary association expected a limited impact in those MS where depositaries already perform a similar role to that envisaged by the advice (e.g. Luxembourg or Germany) and a much more significant impact in other MS e.g. the UK, particularly for RE and PE funds.

410. One banking association felt the oversight duties were very extensive and that the corresponding obligations on the AIFM to e.g. grant rights to access were missing.

411. An institutional investor was generally supportive of the advice on oversight duties but had some concerns on how this would be implemented in practice since some of the duties would be new to AIFs. In particular, the respondent wondered to whom the depositary would escalate matters as set out in the third paragraph of Box 82.

89. **ESMA's response:** ESMA took into account the feedback provided by stakeholders on this point when finalising the advice on the depositary's oversight duties.

Q.41 Could potential conflicts of interest arise when the depositary is designated to issue shares of the AIF?

412. Several respondents (covering investment management, depositary and institutional investor representatives) felt that there may be situations in which a conflict of interest would arise and that such situations should be addressed by ensuring that there are adequate procedures in place to segregate both functionally and hierarchically the functions of depositary and transfer agents or that the provisions in the Directive on functional and hierarchical separation and Article 20(2)(b) on delegation were sufficient safeguards. Similarly, three depositary associations felt that the requirements in the AIFMD on prevention of conflicts of interest should allow the same legal

entity to act as depositary and transfer agent (investor protection being ensured by the use of Chinese walls).

413. One investment management association was of the view that issuance of shares was a matter for the AIF and its administrator, and that the only role for the depositary related to receipt of subscription proceeds and its oversight duty under Article 21(9)(a).

414. One private equity association saw a potential for conflicts and stressed the need for the oversight and manager role to remain separate.

90. **ESMA's response:** Since most respondents felt that any conflicts of interest in this context would be addressed by the requirements on functional and hierarchical separation, ESMA did not introduce any further changes in its advice.

Q.42 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?

415. One stakeholder noted that in certain jurisdictions, this was done by carrying out oversight of the transfer agent e.g. on-site inspections to review processes and controls and sample testing of shareholder activity.

416. One investment management association considered this activity to be somewhat removed from the depositary function due to the involvement of the administrator, noting that the depositary's role would extend to ensuring that appropriate investor acceptance and reconciliation procedures were in place.

417. From the real estate perspective, one stakeholder explained that corporate funds and some institutional real estate funds may be unitised, in which case there is internal reconciliation of subscription orders with subscription proceeds; in contrast, many 'private equity real estate funds' were not unitised and they dealt with reconciliations internally. The same stakeholder added that, in a closed-ended fund, subscription did not happen at the same time as funding, which is drawn down over time as investments are made thereby removing the need for reconciliation.

418. Several depositary associations stressed that the verification of procedures by the AIF/AIFM should not necessarily be correlated to the frequency of subscription and redemption and that periodic verification was sufficient; as such, the additional layer of complexity inherent in some transactions (equalisation methods, commissions, retrocessions) should fall outside the scope of the depositary's oversight.

419. Two respondents explained that the current practice is that the depositary:

i) on a periodic basis, ensures that the AIF, the AIFM or the designated entity (transfer agent and administrative agent) have appropriate procedures in place to reconcile the subscription orders with the subscriptions proceeds;

ii) ensures that the procedure is reviewed on a regular basis and updated if necessary;

iii) checks to ensure consistency between the total number of units or shares in the AIF's accounts and the total number of outstanding shares or units that appear in the AIF's register.

420. One banking association supported the aim of aligning the AIFMD and UCITS requirements on oversight duties as set out in paragraph 54 of the Explanatory text.

421. One institutional investor representative explained that for AIFs with depositaries, this function was usually performed by the administrator which would then make the reconciliations available to the depositary for review. For AIFs that currently did not have depositaries, the AIFM undertakes the function, which is subject to independent audit as part of the preparation of the annual accounts.

91. **ESMA's response:** ESMA is grateful to respondents for providing additional information on the current market practice in this context, which was taken into account in the finalisation of the advice.

Section 2 Due diligence duties

Box 88 (Due Diligence Requirements)

422. Many respondents generally supported ESMA's proposals but made a number of specific drafting suggestions.

423. One investment management association welcomed ESMA's proposals but sought clarification that in the case of delegation by a sub-custodian of its custody functions, the due diligence requirements should apply mutatis mutandis to the relevant parties in the custody chain (in line with the requirements on segregation in Box 89, paragraph 3).

424. Two depositary associations welcomed the proposals, which they considered to be in line with market practice, but regretted the fact that ESMA had not chosen to develop a comprehensive template of evaluation, selection, review and monitoring, which in their view would have helped clarify the duties of depositaries.

92. **ESMA's response:** In light of the broad support from respondents for the requirements on due diligence are largely unchanged in the final advice. ESMA did, however, remove the reference to enforceability of contractual agreements in light of comments from some respondents that this created unnecessary confusion. A requirement has also been introduced on the depositary to notify the AIFM where the depositary becomes aware that the segregation of assets is not, or is no longer sufficient to ensure protection from insolvency of a sub-custodian in a specific jurisdiction. This addresses a number of requests made by investment management representatives with respect to Box 74. Finally, ESMA has added some text to make clear that the requirements of paragraph 1 apply all along the custody chain.

Section 3 Segregation

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

425. Many respondents considered the requirements adequate and reasonable.

426. Several stakeholders sought clarification on the practical implications of paragraph 5 on p.176 of the CP in relation to the extension of segregation to record keeping (in the case of such a requirement, there was some support for the notion that it should be limited to cases where the depositary has appointed the delegate). Two associations felt that depositaries would not have a role in appointing the third parties carrying out record keeping and considered such a requirement as going beyond L1.

427. One investment management association asked for the reference in the explanatory text to the use of omnibus accounts by sub-custodians to be included in Box 89. On a related point, a prime broker association believed that the L2 measures should take full account of the fact that the local laws/market practices of certain jurisdictions in which a sub-custodian operates may require that all assets be held in a single account. One institutional investor had no objection to the use of omnibus accounts provided there was no adverse impact on the level of investor protection. Two depositary associations supported the absence of a requirement to segregate assets on a fund-by-fund basis and the possibility to use omnibus accounts, in line with current market practice.

428. Two depositary associations noted that further segregation requirements with respect to cash at sub-delegate level would not add protection to cash holdings in case of an insolvency of the sub-delegate (whether in the EU or elsewhere). The same respondents favoured deletion of paragraph 1(e) on the basis that cash is recognised as a fungible asset and should not be segregated, and of paragraph 2 on the basis that the depositary could not be expected to assess national insolvency frameworks. In contrast, one institutional investor considered paragraph 2 a key requirement and felt that it should be supplemented by a disclosure obligation to the AIF/AIFM. The same stakeholder agreed with the approach set out in paragraph 3 to apply the requirements mutatis mutandis along the custody chain on the basis that this would give comfort both to the depositary and the AIFM that the level of protection of the AIF's assets is not diluted by subsequent delegations.

93. **ESMA's response:** In drafting the advice in this context, ESMA has kept in mind the need to have strong duties in the case of 'other assets' that fall outside the scope of the custody obligation. ESMA is keen to avoid a situation in which the holding of assets can be structured in such a way that the custody obligation (and the associated liability regime) is avoided. ESMA has therefore considered it appropriate to confirm the need for segregation with respect to 'other assets'.

94. ESMA also considered it appropriate to align the segregation requirements as closely as possible with the provisions of Article 16 of the MiFID Level 2 Directive, in the interests of cross-sectoral consistency. The way in which this has been done in paragraph 1(a) in particular takes due account of the reference in recital 40 to the use of omnibus accounts for multiple AIFs.

Q.46 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?

429. One investment management association explained that the current market practice was for depositaries to open single beneficiary account, often at sub-custodian and central securities depositary level.

430. The following additional steps that could be taken by depositaries in order to have additional protection of the assets were identified:

- Disclosure to the AIF and AIFM so that this aspect of custody risk is properly taken into account in the investment decision
- Depositaries taking such measures as possible in the local jurisdictions to make the assets as 'insolvency-proof' as possible based on local law advice
- Depositaries might undertake appropriate levels of ongoing monitoring to ensure that the relevant sub-custodian continues to comply with the criteria for selection set out in Box 88 – this may involve an enhanced level of credit monitoring or enhanced levels of reconciliations work or other measures to pick up any early warning signals of potential problems
- Crucially, foreign players can be a powerful voice to incentivize legislators, regulators, local market participants in a jurisdiction to improve their client asset protection regimes or processes
- More frequent reconciliations
- Use of buffers
- Prohibitions in temporary deficits in client assets
- Putting in place arrangements prohibiting the use of a debit balance for one client to offset a credit balance for another
- Assets should be registered in the name of the fund (or its general partner in the case of a limited partnership) so as to avoid any questions about segregation ().

431. Several associations felt there should be a recognition that local legislation and court decisions prevailed in all disputes and that the depositary could not ensure that assets held by a sub-custodian are fully protected from insolvency by means of segregation.

432. One investment management association considered that where such additional measures might be unduly burdensome or significantly increase costs, the AIF should not be obliged to make use of them subject to appropriate disclosure to prospective investors.

433. One investment management association noted that in relation to paragraph 2 of the Box, the depositary should be obliged to notify the AIF/AIFM when it becomes aware that segregation of

assets is not sufficient to ensure protection from insolvency of a sub-custodian in a specific jurisdiction; in the absence of such a notification, any assets lost as a result of the insolvency should not be considered an external event in accordance with Box 91.

434. One depositary association felt that all that could be reasonably expected was for the depositary to seek clarification of confirmation as to the conditions under which assets are held while stressing that sub-custodians would not be able to provide certainty as to legal effect.

95. **ESMA's response:** ESMA is grateful to respondents for helping to identify possible additional measures that could be taken by depositaries in order to protect the assets where segregation is not recognised. These measures have been included in the explanatory text in order to provide concrete steps that can be taken by the depositary. Regarding the comments made in relation to the role of local court decisions, it is clear that such decisions will be crucial in many cases. However, the role of the implementing measures is to provide a clear framework for the entities involved and which may be taken into account in any legal proceedings that arise.

Q.46 In which countries would this be the case? Please specify the estimated percentage of assets in custody that could be concerned.

435. Most respondents were not able to identify in which countries such risks would arise. However, a member of one investment management association estimated that it was acting through single beneficiary accounts in about one third of the 105 markets in which it operates. These assets, held mostly in emerging markets, accounted for approximately 3% of total holding for the firm in question. The association concerned asked ESMA to draw up and make public a list of relevant jurisdictions.

436. Another association identified the following jurisdictions as not recognising the concept of beneficial ownership: Argentina, Indonesia, Mexico, Pakistan, Russia and Thailand.

437. One depositary association considered it difficult to draw up a list of jurisdictions as it would be subject to change due to constantly changing legislation and added that issues related to assets being more exposed to insolvency or benefiting from less protection related more to the AIF's risk management policy than the depositary's liability.

96. **ESMA's response:** ESMA is grateful for the feedback provided on this point. At this stage ESMA considers that it would be difficult to draw up a list of countries, particularly given the apparent lack of information among market participants.

V.IV. The depositary's liability regime

1 Loss of financial instruments

Box 90 (Definition of loss)

438. There was broad support among respondents (covering investment management and depositary representatives) for the approach taken in the advice.

439. One investment management association felt that the depositary should be bound to co-operate in good faith to the documented process set out in Box 90, paragraph 2, and to share with the AIFM any document or evidence likely to facilitate the assessment of the loss. Regarding the penultimate sub-paragraph, the same respondent took the view that it should be for the depositary to monitor the insolvency proceedings rather than the AIFM.

440. Several stakeholders sought clarification of 'stated right of ownership' (they preferred a reference to the financial instruments themselves being lost or to the AIF's right of ownership in order to avoid any claimed right of ownership being captured – condition (b) would then become unnecessary). These respondents were also of the view that not being able to dispose of an instrument did not necessarily result in a loss. One private equity association proposed an amendment to cover situations where the assets cannot be disposed of due to an insolvency affecting the issuer of an investment or the effect of a contractual provision agreed by the AIFM.

441. One depositary association made the following points:

- the depositary should not be liable for events outside its sphere of control and influence; as such, where fraud has been committed whereby the financial instruments never existed, there should be no obligation to return the assets.
- liability should attach to the depositary only in case of a 'wrongful action or omission' of the depositary;
- the requirement to notify investors should be clarified, in particular what approach should be taken in case of a dispute over whether there has been a loss and/or whether such loss is covered by the liability exemption of an external event;
- a depositary cannot 'determine' whether the assets are lost in the case of insolvency of a sub-custodian as this is ultimately a matter for the courts; at best a depositary could provide a non-binding preliminary assessment.

442. One institutional investor representative felt that the 'loss' was defined too narrowly and proposed the following alternative: 'the AIF is unable to directly or indirectly dispose of the financial instruments having regard to the reasonable expectation of investors in the AIF.' The same respondent also felt that in the case of the insolvency of an affiliated sub-custodian ('affiliated' to be defined broadly), financial instruments should be considered lost upon the opening of the insolvency proceedings in relation to that sub-custodian. Finally, this stakeholder believed that the determination of whether an asset is lost should be made by the AIFM in consultation with the depositary.

97. **ESMA's response:** The requirements on the definition of 'loss' are key in that they represent the first step towards determining the liability of the depositary to return the asset or a corresponding amount. Taking into account the broadly positive feedback on this aspect, ESMA did not make substantial changes in the final advice. ESMA did consider it appropriate, however, to reflect comments from some respondents in order to clarify that the ownership right

referred to in paragraph 1(a) should be that of the AIF. On balance, ESMA also agreed that the obligation to monitor the insolvency proceedings should apply both the AIFM and the depositary. Finally, ESMA has clarified that the obligation to inform investors is triggered regardless of whether the depositary has been, or is subsequently held liable for the loss and obliged to return financial instruments of an identical type or the corresponding amount.

2 External events beyond reasonable control

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

443. Respondents expressed mixed views on ESMA's proposals in this area. Some stakeholders supported the proposal on the basis that it was consistent with the principle set out in Article 21(13) i.e. that the depositary's liability is not affected by any delegation. Others considered that it would be reasonable for the depositary to be exonerated from liability provided that it has fulfilled the segregation and due diligence requirements set out in the Directive. An intermediate position was held by some respondents, namely that paragraph 1 could be restricted to cover acts and omissions of sub-custodians that are affiliates of the depositary.

444. A number of respondents were of the view that acts and omissions of an unaffiliated sub-custodian should be presumed to be 'external' and set out a number of arguments as to why it would be inappropriate to take a different approach (e.g. this would represent a de facto amendment of L1 and lead to increased capital costs). There was willingness among some of these stakeholders, however, to envisage considering events at affiliated sub-custodians as 'internal'.

445. One settlement system agreed that loss of securities resulting from fraud, insolvency or default of a clearing or settlement system (which would be very unlikely) should be seen as an external event beyond reasonable control.

98. **ESMA's response:** ESMA recognises that is difficult to identify an approach on this point which would attract strong support across both the investment management and depositary sectors. In reaching a final view, ESMA focused in particular on the provision in Article 21(13) of the Directive that the depositary's liability is not affected by any delegation, as well as the general principle that the same event occurring at the level of a sub-custodian should be treated in the same way as if it had happened at the depositary itself. From that perspective, ESMA did not feel it was appropriate to take a different approach for affiliated versus unaffiliated sub-custodians, as the depositary should be aware of the possible significant consequences of a delegation in all cases.

Box 91

Paragraph 1

- Two depositary associations felt that only improper acts or failures of the depositary should be captured; one added that the obligations referred to should be limited to those set out in the Directive.

  ESMA's response: As set out above, ESMA did not see merit in restricting the responsibility of the depositary in this way and was concerned that a reference to 'improper' would leave too much scope for interpretation. ESMA also considered limiting the scope of the obligations to those set out in the Directive but took the view that important obligations could also arise on the basis of e.g. contractual agreements. ESMA did, however, feel it necessary to clarify the wording in paragraph 1 of the box ('The event which led to the loss ~~did~~ is not ~~occur as~~ a result...').

<u>Paragraph 3</u>

- Three depositary associations felt that there should be a reference to 'reasonable efforts' instead of 'rigorous and comprehensive due diligences'.

- Two other respondents favoured deletion/clarification of the text on the basis that this overlapped with the responsibilities of the AIFM as required by Article 8(1)(c) of the Directive.

  ESMA's response: The term 'reasonable efforts' used in the Level 1 text is expanded on in points (a) to (c) of paragraph 3. ESMA deliberately chose the term 'rigorous and comprehensive due diligences', meanwhile, in order to set a high standard for the due diligence to be done by the depositary both with regard to its own internal structure and, where relevant, when selecting a sub-custodian.

  ESMA considers that the duties of the depositary as set out in the box, and in particular the requirement in paragraph 3(a), do not overlap with those of the AIFM pursuant to Article 8(1)(c) of the Directive. It is natural that the depositary will be required to have a good level of knowledge and expertise in relation to the nature and complexity of the assets of the AIF in order to be able to perform its duties. This is without prejudice to the AIFM's role as investment manager.

<u>Paragraph 3(a)</u>

- One depositary association called for the text to be revised to qualify the depositary's obligation to monitor for any external events with a duty to act reasonably.

  ESMA's response: ESMA agreed with the suggestion and introduced revised wording ('external event it could reasonably identify') in the final advice.

<u>Paragraph 3(c)</u>

- One depositary association suggested deletion of the text on the basis that the reference to 'appropriate actions...to prevent or mitigate a loss of financial instruments held in custody' could cause problems where the situation is not clear enough for the depositary to know whether it should independently take a decision.

ESMA's response: ESMA notes that it is impossible to identify exhaustively all the circumstances which may arise in the market and has therefore focused on developing clear principles that will help market participants in complying with their obligations. ESMA considers paragraph 3(c) important in that it imposes an obligation on the depositary to take remedial action where appropriate in order to prevent or mitigate loss.

Explanatory text

Paragraph 29

– Two depositary associations disagreed as they felt that fraud at a sub-custodian should be considered external provided the depositary has satisfied the due diligence requirements. One of the associations was of the view that the proposed approach amounted to imposing strict liability on depositaries.

ESMA's response: As noted above, ESMA took into account the clear requirements of the Directive in reaching its view on the appropriate approach to take in relation to depositary liability. The first step of the assessment of whether the depositary is liable to return a lost asset is to determine whether an event is 'external'. To the extent that an event occurring at the level of the sub-custodian should be treated in the same way as an event occurring at the depositary itself, the event cannot be considered 'external' and the liability to return the asset or a corresponding amount is triggered.

Paragraphs 38 & 39

– Several respondents expressed concerns about the proposal set out in paragraphs 38 and 39 under Box 91 on the basis that, inter alia: it was not realistic and too long; it did not strike the balance that ESMA was seeking; it could create legal uncertainty in times of crisis; the depositary should not be expected to carry out a quasi-investment management function; the depositary would not necessarily know the identity of the investors. Two depositary associations added that where the depositary has made a notification to the CA, it should be discharged of liability for any resulting loss. The same respondents also suggested requiring AIFMs to cover this in the pre-investment disclosures to investors under Article 23(d).

ESMA's response: ESMA maintains its view that, in order to balance the roles and responsibilities of the AIFM and the depositary in circumstances of the type described in paragraphs 38 and 39 of the CP, the possibility for the depositary to discharge its liability or terminate the contract should not be ruled out. Indeed, these measures provide a good incentive on the AIFM to take into account the depositary's warnings and to act before a discharge of liability or termination of the contract becomes necessary.

3 Objective reasons to contract a discharge

Box 92

446. A large majority of members of one investment management association disagreed with the proposal in option 2, considering it incompatible with the L1 text in the sense that the existence of a written contract did not – in their view – by itself constitute an objective reason. This association preferred option 1 for reasons of clarity. An institutional investor representative took a similar view, arguing that option 2 was too open-ended and that it was hard to envisage circumstances in which an AIF/AIFM, acting in the interests of the investors of the AIF, would explicitly agree to discharge the depositary's liability in circumstances beyond those set out in option 1.

447. Many other respondents supported option 2 on the basis that, inter alia, it was clearer and more objective, any other approach would favour the largest banks, it was the most pragmatic option and the notion of 'best interests of the AIF and its investors' was too broad, option 1 did not provide legal certainty on such notions as 'no other option' and 'agreed...it is in the best interest', and that it gave the necessary flexibility.

99. **ESMA's response:** Having reflected further on the two options in the light of feedback from respondents, ESMA took the view that neither of the alternatives set out in the CP was fully appropriate. In particular, ESMA agreed with the concerns raised with respect to option 2, such as that it was too open-ended and raised questions of consistency with the Level 1 text. However, ESMA was also of the view that option 1 as drafted, taking into account the additional flexibility in the new paragraphs 44 and 45 of the explanatory text, did not strike the necessary balance. Option 1 was redrafted, therefore, in order to give the AIFM the responsibility to determine whether it is in the best interests of the AIF and the investors for the depositary to discharge its liability.

Q.47 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?

448. A study commissioned by one investment management association suggested that a 'strict liability' approach for acts or omissions of all sub-custodians would increase costs by 4-5 times.

449. One private equity association foresaw a significant increase in costs due to the resulting need for depositaries to price risks they face into their charges and the need to duplicate work done by others e.g. auditors.

450. Several respondents expected a significant increase in costs for depositaries as well as an increase in systemic risk.

451. Two stakeholders noted that assuming AuM of AIFM of €2 trillion (as set out in the Commission's original Directive proposal), even a one basis point increase would lead to additional costs of €200 million.

452. One prime broker representative explained that if depositaries were effectively made strictly liable for losses of assets, this would most likely be considered a contingent liability against which regulatory capital of 8% would need to be held. This respondent was of the view that this would be beyond the ability of the AIF industry to absorb and would discourage most prime brokers (who currently provide custody services for the vast majority of hedge funds balances) would no longer offer such services, or would have to significantly increase costs in order to do so. The same respondent highlighted what it saw as potentially significant systemic risks arising from such an approach.

100. **ESMA's response:** ESMA took into account the information provided on possible costs in finalising its advice. However, ESMA also had to pay close attention to the proper interpretation of the Level 1 Directive, as set out above, which foresees a strong approach to depositary liability.

Q.48 Please provide a typology of events which could be qualified as a loss in accordance with the suggested definition in Box 90.

453. One investment management association felt that a principles-based approach as set out in Box 90 was more appropriate than a typology, which would inevitably fail to capture certain circumstances. Several banking associations agreed but proposed the following non-exhaustive typology:

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

- Fraud resulting in the permanent loss of the financial instrument

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

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

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

- Change in relevant law e.g. due to the adoption of or change in any applicable law or regulation (including tax laws) it becomes illegal to hold, acquire or dispose of the financial instruments.
- In some cases, government action may result in 'loss' e.g. where a government (or governmental institution or agency) has taken action which had the effect of permanently and irretrievably preventing the transfer, sale or other disposition of the financial instruments.
- In some cases, national or international embargoes i.e. a government (or government institution or agency) or an international organisation has announced a trade embargo affecting the ability to transfer, sell or dispose of the financial instruments) may be sufficiently permanent that the

- Liquidation, dissolution or winding up of issuer (ESMA rightly recognises, only where it becomes certain during (or at the end of) the insolvency process that the financial instruments are permanently and irretrievably lost).

454. One investment management association identified the following circumstances based on the proposed definition in Box 90:

(a) Fraud resulting in the permanent loss of the financial instruments

(b) Nationalisation of the issuer

(c) Change in relevant law, government action, national or international embargoes and liquidation, dissolution or winding up of issuer.

455. One institutional investor representative did not see the need for a typology if the definition in Box 90 was retained.

101. **ESMA's response:** ESMA is grateful to respondents for the input provided with respect to a possible typology of events that would constitute a loss. However, ESMA did not consider it necessary to include such a typology in its advice and is of the view that the definition in Box 91 is sufficiently clear.

Q.49 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?

456. The majority of respondents supported this approach although some sought clarification on the 'effects of segregation'. One depositary association recommended that the reference to local legislation not recognising 'the effects of segregation' be extended to the decisions of 'courts and regulatory bodies'. One institutional investor representative explained that investors were not expecting depositaries to underwrite custody risk but insisted on the need for proper disclosure, as well as application of the requirements on due diligence and ongoing monitoring.

102. **ESMA's response:** Taking into account the support of the majority of respondents, ESMA has confirmed this approach in its final advice. Segregation is a well-known concept in the world of financial services; as such, ESMA did not see a need to define 'effects of segregation' further at this stage.

Q.50 Are there other events which should specifically be defined/presumed as 'external'?

457. One investment management association was of the view that no event should be a priori defined as external (even acts of God) and that an assessment should always be made taking into account all the facts and circumstances.

458. One banking association also preferred a principles-based approach but identified all operational failures outside the sphere of influence of the depositary and its network as well as claims of third

parties to be the true legal owner of a financial instrument. The same respondent also saw merit in extending Box 65 (Objective reasons for delegation) to depositaries.

459. Two associations identified the following non-exhaustive list:

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

460. One institutional investor representative also identified acts, omissions and insolvency of a securities depositary or settlement system as an external event, along with events pertaining to country risk, political risk and/or market risk.

461. Two depositary associations provided a detailed list of events covering the following broad categories: i) settlement system rules, market practices or other market infrastructure-imposed constraints; ii) Local market problems; iii) Local market conditions; iv) Appointment of counterparties by AIFM; v) Other external events.

462. One depositary association identified the unavailability of infrastructure as a difficult issue, particularly where the infrastructure is owned or operated by third parties and the only relationship the depositary has with the owner or operator is through a services contract or software licence (the respondent's view was that in the latter case, the event should not be considered 'internal').

103. **ESMA's response:** Taking into account the mixed views expressed by stakeholders on this point, ESMA decided to maintain its principles-based approach to the determination of external events.

Q.51 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?

463. Several respondents reiterated their views that the proposed advice would limit unreasonably the types of event that would qualify as 'external' and that the depositary's sphere of influence was limited.

104. **ESMA's response:** As noted above, ESMA decided to maintain its principles-based approach with respect to the distinction between external and internal events.

Q.52 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?

464. One investment management association was of the view that many sub-custodians would be unwilling to assume liability over and above their own fraud (and possibly negligence) and that such transfers could come up against practical difficulties in any case (such as laws not permitting third party rights).

465. One private equity association was keen to avoid an approach that drove business into banks with huge proprietary networks.

466. Two depositary associations envisaged transfers where the AIF wishes to make use of prime brokers and sub-custodians that did not meet the eligibility criteria for depositary banks, or where a particular sub-custodian is imposed on the AIF by the depositary, but noted that it might be difficult to implement in practice as a result of local of harmonisation of regarding the definition and requirements to achieve an effective transfer of liability.

467. One banking association saw difficulties in implementing such transfers in practice due to the inherent disadvantages to the sub-custodian, except where the depositary acts with the sub-custodians (and their local jurisdiction) and accepts that the AIF (or the AIFM) may directly place a claim with regards to assets in custody.

468. One prime broker representative considered it unlikely that sub-custodians within the prime broker's custodial network would accept any direct right of recourse from the prime broker's clients, given that there is no direct relationship with the AIF.

469. One depositary association was particularly concerned about the references in paragraphs 42 and 45 of the Explanatory text under Box 92 relating to the transfer of liability all along the custody chain, noting that the UK 'Contracts (Right of Third Parties) Act 1999' would mean that no sub-custodian arrangement could be changed without the consent of each and every AIFM acting for AIFs holding assets through the sub-custodian. More generally, this respondent was concerned that a proposal providing for potential transfer of liability to sub-custodians would detract from the depositary's fundamental role of selecting the best sub-custodian available.

470. One banking association doubted the feasibility of transferring the liability in practice on the basis that sub-custodians were unlikely to accept.

105. **ESMA's response:** The possibility for the depositary to discharge its liability is envisaged by the Directive. ESMA has clarified in its advice the circumstances in which the depositary should be considered to have an objective reason to do so. It will be for market participants to decide to what extent they wish to make use of this option taking into account the requirements of the Directive and the future implementing measures.

Q.53 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?

471. One investment management association considered the advice to be workable assuming that the assets were not to be considered 'financial instruments that can be held in custody' under Article 21(8).

472. One private equity association reiterated its concerns regarding the lack of tailoring for PE/VC funds using non-bank depositaries and cross-referred to its specific proposals elsewhere in the response.

473. Two depositary associations favoured limiting the extent to which non-bank depositaries could acts as custodians for financial instruments. A third felt the framework was workable for PE and RE funds, provided option 2 was chosen in Box 78 and option 1 in Box 81.

474. One banking association stressed the need to ensure a level playing field in the EU and for third countries between all depositaries.

106. **ESMA's response:** In developing the advice on depositaries, ESMA has sought to ensure a level playing field between depositaries that are credit institutions and those that are not, also with respect to the level of protection given to the assets of the AIF.

Q.54 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?

475. One depositary association sought further tailoring of the distinction between custody and other assets and highlighted its desire to see consistency between the UCITS and AIFMD frameworks.

476. One banking association saw a need for greater tailoring with regard to the 'beyond reasonable control' test, on the basis that what is reasonable for a more 'traditional' AIF may not be reasonable for an AIF engaged in intra-day trading.

477. For one depositary association, the key tailoring required was in the distinction between safekeeping duties in respect of financial instruments held in custody versus other assets subject to record keeping and oversight duties.

478. One banking association felt the more diversified nature of AIFs (compared to UCITS) had to be taken into account but not to the detriment of harmonisation.

107. **ESMA's response:** Throughout its advice, ESMA has made efforts to tailor the requirements to the different types of AIFM where appropriate. With respect to the distinction between financial instruments to be held in custody and 'other assets' for the purposes of safekeeping, the reasoning behind ESMA's advice is set out elsewhere in this document.

Possible Implementing Measures on Methods for Calculating the Leverage of an AIF and the Methods for Calculating the Exposure of an AIF

Box 93: General provisions on calculating the exposure of an AIF

479. Many respondents strongly disagreed with the proposal in Box 93 to require the calculation of the AIF according two or even three different methodologies, as well as, the disclosure of the level of leverage based on two methodologies. Calculation based on a single methodology should be enough and the choice of the calculation methodology should be left to the AIFM.

108. **ESMA's response:** ESMA carefully analysed the call from many respondents to calculate the leverage according to only one method instead of two and potentially three. However, ESMA was not convinced by stakeholders' arguments and remains convinced that there should be at least two different calculation of the leverage according to the gross method and the commitment method. In addition to these two calculations, if it deems appropriate, AIFM may calculate the leverage according to a third method (the advanced method) after having notified its competent authority.

Box 94: Exposure related definitions

480. For many respondents, the definitions of netting and hedging arrangements were highly restrictive and did not reflect the market practice.

109. **ESMA's response:** ESMA decided to keep the definition unchanged in order to ensure the comparability with the Commitment Approach as defined in the CESR guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS. However, Box 94 has been deleted in the final advice and the definitions have been included in the relevant boxes.

110. Box 95: Gross method of calculating the exposure of the AIF

481. Several respondents pointed out that for funds that almost invest entirely in futures the outcome of the gross or commitment methods did not provide with an appropriate indication of the risk incurred. The same respondents also pointed out that borrowings should be excluded from the gross method when they are reinvested – as the re-investment is already captured.

482. Several respondents strongly disagreed with the use of gross method as proposed by ESMA. According to them, the most appropriate method should be an adjusted commitment/gross method. However, some respondents believed that the gross method could be used for reporting obligations to competent authorities with some modifications.

483. An alternative method was proposed by investment manager association. This method consisted in treating derivatives exposures in the line with the treatment of derivatives under Basel III regime which as recently proposed in the CRD IV.

111. ESMA's response: ESMA believes that information on the level of leverage calculated on the basis of the gross exposure is of utmost importance in the context of monitoring systemic. Moreover, further information on the level of the leverage calculated according to the Commitment Method will allow competent authorities and investors to understand the impact of the netting and hedging arrangements on the leverage of the AIF.

Box 96: Commitment method of calculating the exposure of an AIF

484. For many respondents, the definitions of eligible hedging arrangement were too restrictive and unhelpful and some members of the of the trade association considered important that ESMA should ensure consistency of the commitment method with the UCITS calculation methodology for the commitment approach.

485. The proposition to take into account hedging arrangements only when there is no return generated and where the sole aim is to eliminate a countervailing risk was not supported by several respondents. However, while being too strict, the same respondents welcomed the possible use of netting arrangements which permit duration matching rules for interest rate strategies.

112. ESMA's response: ESMA believes that there should be consistency between the methods used by UCITS management companies and AIFM to calculate the exposure of the funds and that method should be aligned to the UCITS method as provided by the CESR guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS. Therefore, the rules applicable to netting and hedging arrangements have not been modified and additional provisions of the CESR guidelines have been introduced in the final advice (exclusion of derivative instruments from the calculation of the exposure of the AIF under certain circumstances and duration netting rules as provided by Box 3, 4 and 7 of CESR guidelines).

113. Box 97: Advanced method of calculating the exposure of an AIF

486. Several respondents disagreed with the requirement to calculate the advanced method besides the commitment method, instead of as an alternative to it.

487. For one stakeholder it was not clear how the advanced method would reduce the complexity since leverage calculation according both gross and commitment methods must be performed.

114. **ESMA's response:** Following the feedback received from the consultation, ESMA has decided not to change the approach. Indeed, the Advanced Method has been introduced in order to relax the rules applicable to the Commitment Method with in particular the possibility for AIFM to use offsetting arrangements which are not allowed under the Commitment Method. ESMA believes that the Advanced Method should only be used on a voluntary basis in addition to the Gross and the Commitment Method which are compulsory. However, in terms of information to be provided to investors under Article 23 of the Directive, AIFM, in addition to the Gross Method figure can choose between the Commitment Method and the Advanced Method. It has also been agreed that ESMA would develop guidelines in order to provide more details in the application of the Advanced Method.

115. Box 98: Method of increasing the exposure of an AIF

488. It was suggested by some respondents to better align the definition of futures contract and forward agreements with the definition of the CESR guidelines on Risk Measurement and the Calculation of the Global Exposure and Counterparty Risk for UCITS.

116. **ESMA's response:** When necessary, the definitions have been aligned to the CESR guidelines on Risk Measurement and Counterparty Risk for UCITS.

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?

489. Respondents to the consultation expressed some support for the proposed list and suggested the inclusion of additional methods such spread betting or credit default swaps.

117. **ESMA's response:** Based on the feedback received, ESMA added to the list of methods for increasing the exposure of the AIF the definition of spread betting and credit default swaps.

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?

490. Many respondents to the consultation took advantage of answering this question to reiterate their call to ESMA to reconsider the use of VaR as an alternative to the gross and commitment method where appropriate for the particular AIF.

491. It was pointed out that the calculation of exposure seemed to be designed for hedge funds and not for private equity or venture capital funds. Therefore, it would be appropriate and proportionate for ESMA to include an additional, simple test to determine whether a given private equity and venture capital AIF is leveraged or not.

118. **ESMA's response:** As explained above, ESMA kept the advice unchanged with regards the calculation of the exposure in accordance with the Advanced Method. Furthermore, ESMA disagreed with the suggestion made by several respondents to introduce the possibility of calculating the leverage according to the VaR. Indeed, ESMA is of the view that the VaR is not a measure of the leverage which is defined as the ratio between the exposure of the AIF and its net asset value. ESMA acknowledges that UCITS can use the VaR but only in the context of the calculation of global exposure. Indeed, Box 24 of CESR's guidelines on Risk Measurement and the Calculation of Global Exposure requires UCITS management companies calculating the global exposure of the funds according to the VaR approach to disclose in the prospectus the leverage of the UCITS as a separate figure.

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

492. According to several respondents there was no need for further clarification.

493. For one stakeholder, in order to avoid the risk of inconsistent valuations and duplicative costs, ESMA's advice should provide that the valuation of contingent liabilities and credit-based

instruments should be based on the accounting principles used in the AIF's financial statements determined in accordance with the Directive.

119. **ESMA's response:** Based on the comments received from the consultation, ESMA did not feel necessary to provide more information in relation to the treatment of contingent liabilities or credit-based instruments.

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?

494. The majority of respondents agreed that when an AIFM calculates the exposure according to the gross method, cash and cash-equivalent which provide a return at risk-free rate and held in the base currency of the AIF should be excluded. Some of these respondents also felt that the definition 'cash and cash equivalent' should be addressed.

120. **ESMA's response:** In light of the feedback received, ESMA has decided to keep the approach taken in the consultation paper unchanged and to exclude from the calculation of the exposure according to the gross method cash and cash-equivalent. As suggested by some respondents, ESMA has decided to provide more clarity on the definition of cash equivalents which provide a return at the risk-free rate. In the final advice, ESMA recommends that cash equivalents should be assets which are highly liquid investments held in the base currency of the AIF that are readily convertible to a known amount of cash, subject to an insignificant risk of changes in value and which provide a return no greater than the rate of the 3-month high quality government bond

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

495. Respondents to the consultation did not express a strong preference for one of the three options identified and proposed by ESMA.

121. **ESMA's response:** see question 61 above.

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?

496. Respondents to the consultation expressed mixed views on this question.

497. For some respondents, leverage in a third party entity should only be included in respect of a particular AIF if there was legal recourse such that the AIF's liability exceeds its investment value.

498. For other stakeholders, leverage at the level of a third party financial or legal structure controlled by the AIF should be included in the calculation of the leverage of the AIF on a consolidated basis where material, particularly in the case of real estate funds which prepare their financial statements on a consolidated basis. For these respondents, failing to require the disclosure of such leverage under AIFMD, where material, would ignore a potential source of

systemic risk and could lead to market distortions. Indeed, AIFs that hold assets directly would appear to have higher leverage than AIFs that hold assets indirectly through subsidiary special purpose vehicles entities; leverage in the latter case would not be reported. The trade association pointed out that currently, non-listed real estate funds typically report leverage on a consolidated basis, which leads to a clearer and more directly comparable disclosure of risk associated with such leverage.

122. **ESMA's response:** Based on the mixed views expressed by respondents ESMA decided to take the following approach. Any exposure which is contained in any financial and/or legal structures involving third parties controlled by the relevant AIF should be included in the calculation of the exposure where the structures referred to are specifically set up to directly or indirectly increase the exposure at the level of the AIF. However, for AIFs whose core investment policy is to acquire control of non-listed companies or issuers, AIFM should not include in the calculation of exposure any leverage that exists at the level of those non-listed companies and issuers. ESMA believes that this approach provides clarity on how Recital 78 of the Directive should be interpreted.

Possible Implementing Measures on Limits to Leverage or Other Restrictions on the Management of AIF

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.

499. Some stakeholders disagreed with the proposed approach and believed that it was going beyond what is required in the Level 1 Directive. According to them, the proposal should be restricted to limiting leverage only 'to the extent to which the use of leverage contributes to the build-up of systemic risk in the financial system or risks of disorderly markets' as envisaged in the Level 1 Directive.

500. It was stressed that leverage was not a measure of risk and that therefore, any intervention should be based on sound analysis and evidence of systemic risk.

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?

501. The majority of respondents believed that these powers should be used only in extreme circumstances to avoid any perverse effect on assets prices. Stakeholders were also of the view that the process of deleverage should be carefully analysed by competent authorities prior to any decision due to the systemic implication it may have.

123. **ESMA's response:** ESMA recognises the concerns expressed by some respondents that any decision by competent authorities to limit leverage should be done after due consideration of the

potential impact on assets prices. However, ESMA disagreed with the point made by some respondents that the approach taken by ESMA was going beyond what is required in the Level 1 and decided not to change the advice. Indeed, ESMA believes that the approach provides competent authorities with guidance on the criteria to be considered when assessing the potential impact on the stability and integrity of the financial system.

Possible implementing measures on annual reporting

Box 101: Definition of material change

502. Clarification was asked whether the proposed definition of 'material change' was relevant only to specific transparency requirements and without prejudice to other AIFMD provisions containing references to material changes.

503. For some respondents it was unclear how this definition would work in the closed-ended fund context. According to them, the proposed definition would introduce ambiguity to a process that is currently clearly laid out in the governing documentation of such funds and allows for a certainty of investor oversight. The same respondents also stressed that in a closed-ended fund, investors did not typically have a right to 'reconsider' their investments and felt the determination of whether information would lead an investor to 'reconsider' its investment was subjective. Rather than linking the definition to the subjective determination of a hypothetical investor, the advice should provide that whether a material change has occurred be determined in the reasonable judgment of the AIFM.

504. In relation to the definition of the term 'material', it was suggested that reference should be made to the practitioner's framework for the Preparation and Presentation of Financial Statements approved by the IASC in 1989 and adopted by the IASB in 2011.

124. **ESMA's response:** ESMA believes that the proposed definition of material change would also be applicable to closed-ended funds. Indeed, reconsideration of their investment rights by investors does not mean automatically that investors would ask for redemption but could also cover other rights.

Box 102: General principles for the annual report

505. Several respondents indicated that the AIFMD was unclear as to whether the requirement to produce (as distinct from 'to make available') an annual report applies to the AIFM or the AIF. According to these respondents, the ESMA's consultation paper continues the ambiguity and they would recommend that it be resolved expressly by recognising that while, under level 1, Article 22, the AIFM is obliged to make available an annual report to investors in relation to the funds it manages, the preparation of several components of that report properly belong to the governing body of the AIF itself. Accordingly, it was suggested that the AIFM may discharge itself of its

obligations to make disclosures under Article 22, to the extent that disclosure obligations are met by the governing body of the AIF.

506. It was also recommended that, as under UCITS, where the governing body of the fund prepares the annual statements, the document containing them can be supplemented by the inclusion of an annual Investment Managers Report (a mechanic which is contemplated but not explored in Paragraph 25 on page 225 of the CP).

507. Some stakeholders also believed that the second sentence of paragraph 3 should be deleted as it was not the role of the AIFM to determine what level of information is appropriate for an investor. A similar comment was made for the second sentence of the paragraph 4 and it was also suggested to delete the first sentence of paragraph 4 which was felt to be duplicative with paragraph 3.

508. According to several respondents, ESMA's proposal should not impede AIFMs or AIFs established in an EU-member state to prepare annual reports in accordance with US GAAP and suggested moderating the provisions of paragraphs 2 and 3 of Box 102 to avoid any suggestion that this was the intent.

125. **ESMA's response:** ESMA has decided not to take on board the comment made by some respondents that the provisions of paragraphs 2 and 3 of Box 102 should be modified in order to make sure that AIFM or AIF established in an EU-member state can prepare annual reports in accordance with US GAAP. Indeed, Article 22(3) of the AIFMD provides that 'accounting information given in the annual report shall be prepared in accordance with the accounting standards of the home Member State of the AIF or in accordance with the accounting standards of the third country where the AIF is established and with the accounting rules laid down in the AIF rules or instruments of incorporation'. Therefore, ESMA does not consider that such clarification should be provided in the advice.

126. Box 103: Reporting material changes for the annual report

509. It was proposed that only the first sentence of paragraph 3 should be kept because some respondents felt that it was not the role of the AIFM to speculate as to what additional information may be relevant for an investor. Additionally, the suggestion was made to delete the phrase 'together with any potential or anticipated impact on the AIF and/or investors of the AIF' in paragraph 4.

510. One respondent proposed to align the wording of paragraph 3 with the wording of paragraph 4.

127. **ESMA's response:** ESMA agreed with the comment made to align the wording of paragraph 3 with paragraph 4 and modified the advice accordingly.

Box 104: Primary financial statements

511. Respondents were broadly supportive with the ESMA's proposal. However, some of them disagreed with paragraph 7 (a) (iii) to present unrealised gain because this would be in contradiction with reporting practices in many countries. For some respondents, the distinction

between realised gains and unrealised gains was unnecessarily prescriptive and should be deleted. For one respondent that disagreed with this distinction as well, should ESMA see the necessity to ensure a harmonised presentation of un-realised gains for AIFs, this information should be in the overview of AIF performance to be included in the report on activities.

128. **ESMA's response:** see question 63 below

Box 105: Content and format of the report on activities for the financial year.

512. According to many respondents, paragraphs 24 and 25 of the explanatory text should be moved to Box 105.

513. Several respondents recommended that the phrase 'containing also a description of the principal risks and investment or economic uncertainties that the AIF may face' should be deleted, given that there would already be sufficient disclosures made in accordance with Article 23 of the Directive. The same should apply to paragraph 3 as well according to the two European associations.

514. Some respondents stressed that this report should be the responsibility of the governing body of the AIF, and not the AIFM, unless there was no governing body of the AIF.

129. **ESMA's response:** ESMA did not deem appropriate to move paragraphs 24 and 25 from the explanatory text to Box 105 and disagreed with the deletion suggestion made by some respondents. Therefore, Box 105 was not changed in the final advice.

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?

515. The vast majority of respondents supported the approach proposed by ESMA and some drafting suggestions were done.

516. However, one respondent strongly encouraged ESMA to ensure that private equity and venture capital AIFs and AIFMs may use US GAAP when compiling financial statements and the annual reports.

130. **ESMA's response:** Some drafting modifications were made by ESMA and in particular the advice no longer refers to AIFM preparing financial statements as according to the Directive AIFM are not required to prepare the financial report but only to make the information available to investors.

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?

517. Several respondents considered that remuneration disclosures should be subject to similar exemptions as are available to firms under Directive 2006/48/EC, which effectively allow information which is immaterial, confidential or proprietary to not be disclosed. According to them, 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.

518. ESMA was also asked to clarify whether in the case of umbrella funds the remuneration disclosures should be at sub fund level or umbrella level.

519. Several stakeholders drew ESMA's attention to the fact that when AIF are incorporated as a separate legal entity, those responsible for the financial statements of the AIF will be those in charge of the corporate governance of the AIF. They may differ from the management of the AIFM. In this case, there are likely not to have a direct access to the AIFM records and thus not to be in a position to take responsibility and ownership for such disclosures. Moreover, the auditor of the AIF may not have direct access to the books of the AIFM in order to audit such disclosure.

520. Paragraphs 5 and 6 were considered as going beyond the requirements of the Level 1 and their deletion was suggested.

521. It was also stressed that the proposed provisions would be prejudicial to small managers as individual payments made to principals managing the AIF would be easily identifiable.

522. In the case of large non-listed real estate funds, the disclosure of total remuneration in relation to staff involved in the operations of the AIF was deemed to be impossible.

131. **ESMA's response:** ESMA agreed with the suggestion to delete paragraphs 5 and 6 of Box 106. Also, in the final advice, in paragraph 2 of Box 106 a reference to the number of beneficiaries was added as well as a new paragraph 3 with the mention of carried interest. These amendments were made to reflect better the Level 1.

Possible Implementing Measures on Disclosure to Investors

Box 107: Periodic disclosure to investors

523. Several respondents were of the view that AIF with no periodical redemptions rights should only be required to disclose information relating to paragraphs 1, 2 and 3 in its first disclosure to investors and not be required to do it on a periodical basis. Also, they felt the second part of paragraph 5 under the heading 'Risk Management systems employed by the AIFM' to onerous and not necessarily of immediate interest to all investors. Therefore, this information should be made available to investors on request.

524. It was stressed that Box 107 should be modified to reflect differences among different types of AIFMs and to be consistent with substantive provisions of the AIFMD and related implementing measures. In particular, Box 107 should clarify that disclosure requirements related to liquidity

management do not apply to unleveraged closed-ended AIFs in accordance with Article 16 of the Directive.

525. It was proposed that paragraphs 2, 6 and 7 of Box 107 should contain 'whenever there any material changes' and to add a sentence making clear that paragraphs 4 and 5 did not apply to AIFM in so far as they manage unleveraged closed-ended AIF.

132. **ESMA's response:** ESMA did not see any valid reason for allowing AIF with not periodical redemptions rights to disclose the information under paragraphs 1, 2 and 3 only in their first disclosure. Indeed, the fact that investors in these AIF do not have the possibility to redeem their shares or units on a periodic basis is not reason for not disclosing the percentage of assets subject to special arrangements. However, ESMA agreed with the comment made about paragraph 4 of Box 6 and clarified that it was not applicable for unleveraged closed-ended AIF.

Box 108: Regular disclosure to investors

526. Several respondents expressed some concern on the fact that the draft technical advice was placing too much importance on leverage and in particular gross leverage as useful statistic for regulators and investors. While these respondents generally supported the general proposed approach requiring timely disclosure only in respect of 'material changes' to the maximum leverage and permitting inclusion of information on the actual maximum amount of leverage in the AIF annual report, they were concerned about the requirement to set a maximum level of leverage that must complied with at all times.

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?

527. One respondent believed that for disclosure of risk profile, ESMA should avoid adopting UCITS requirements which are ill-suited to the diversity of AIF risk.

528. Several stakeholders believed that disclosure of new arrangements may impose additional liability (including, but not limited, to conflicts of interest, insider trading, fraud and breach of fiduciary duty) where certain investors are informed of certain special arrangements that do not concern them as in the case of liquidating special purpose vehicles or side pockets.

529. According to some respondents there should not be any notification of the activation of liquidity management tools that have been disclosed to investors in prospectus and offering documents.

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

530. According to some respondents, permanent borrowings and gates should not be considered as special arrangements as they typically apply to all investors.

133. **ESMA's response:** Following the feedback received ESMA decided to exclude gates from the definition of special arrangements.

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

531. The majority of respondents expressed a preference for option 1 as it offers more discretion in making disclosure and should result in higher quality information being provided to stakeholders.

134. **ESMA's response:** in light of the comments received, ESMA kept the option 1 in the final advice. However, ESMA felt necessary to import some elements of the option 2 in the final advice to make it slightly more specific.

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.

532. The vast majority of respondents did not feel necessary for ESMA to be more specific on how the risk management system should be disclosed to investors.

533. It was proposed to delete the reference to 'anticipated impact' on investors in paragraph 6 because the AIFM would not be in a position to make that judgement.

135. **ESMA's response:** Based on the feedback received from the consultation, ESMA did deem necessary to be more specific on how the risk management system should be disclosed to investors.

Possible implementing measures on reporting obligations to competent authorities.

Box 109

534. According to some respondents, ESMA should take into the account the need to minimise the administrative burden on competent authorities arising out of the transparency requirements of the Directive. Therefore, some respondents were of the view that information required by paragraph 1, 3 and 6 should be provided by an AIFM on an annual basis, other than in the case of the very limited number of AIF whose activities and size are such that they might be deemed to have the potential to be systemically significant, in which case quarterly reporting may be reasonable. For this purpose, it was proposed that a benchmark for possible materiality be set at 3 billion of euros.

535. It was also pointed out that the timescale should be determined by reference to the financial year of the AIF rather than a reference to calendar year otherwise competent authorities would be swamped with information.

536. Information required under paragraphs 1(a) and 1(b) was felt not to be appropriate for non-listed real estate funds that do not generally invest in financial instruments. Furthermore, some concern was expressed about paragraph 3(d) (ii) that requires information on the terms of financing provided by counterparties to the AIF which usually are of confidential nature.

136. **ESMA's response:** As explained in the question 69 below, ESMA has modified in the final advice the approach concerning the reporting frequency but did not feel necessary to amend the information requested.

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

537. The vast majority of respondents disagreed with the proposed frequency of disclosure. For several respondents, reporting requirements should be on an annual basis while an approach based on the size of the AIFM was also proposed.

538. Paragraph 5 of Box 109 raised also some concerns among stakeholders that felt it could lead to significant disparity of treatment across the EU and market distortions.

137. **ESMA's response:** In light with the comments received, ESMA moved away from the quarterly reporting as proposed in the public consultation. Indeed, ESMA acknowledges that it may not be appropriate to require systemically all AIFM to report on a quarterly basis. Therefore, ESMA recommends in Box 109 a reporting frequency which is based on the total of assets managed by the AIFM, the size of the AIF itself and the investment strategy.

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.

539. Respondents to the consultation were generally anticipated that the ESMA's proposal would create additional costs (initial and on-going) without being able to provide with any estimation. Respondents also stressed that the costs would vary across the different types of AIFs.

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?

540. Most of the respondents to the consultation disagreed with the reporting deadline and asked ESMA to consider the possibility for a 4-month or 3-month reporting deadline.

138. **ESMA's response:** ESMA strongly believes that the reporting deadline should be kept to one month otherwise the information received by competent would no longer be up-to-date which would be detrimental for the monitoring of systemic risk.

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?

541. For several respondents the ESMA's approach was too subjective and would be interpreted differently by national competent authorities. According to them, ESMA should be more specific with more objective criteria.

542. Some stakeholders indicated that they would appreciate an indication of a ‘safe harbour’ below which an AIFM would not be considered as employing leverage on a substantial basis and proposed that the limit could be set a level of 100% of the AIF’s capital. One respondent agreed with ESMA’s suggestion to use a self-assessment approach.

<u>Reporting Template (Annex V):</u>

139. On the reporting template, ESMA received a limited number of comments which are summarised below:

- Section 1 (1) : under the proposed format, the funds that do not pursue an alternative strategy, which can be very numerous as mentioned above, will be mingled in an ‘other funds’ category including as well infrastructure and commodity funds as well as an ‘other’ category. Why funds with such different profiles are mixed?

- Section 1(3) individual exposures per categories of instruments: A category of cash and cash equivalent (for money market funds) should be added as well as a category ‘other assets’ under point c) real assets (for assets such as art, wine etc.).

- Section 1(3) typical deal size: the type of information required should be clarified.

- Section 1(4): why the G10 bonds are split per maturity and not the Non-G10 bonds? One respondent would also suggest considering the distinction between ‘investment grade’ and ‘non-investment grade’ similarly as for the corporate bonds, as it do not understand the relevance of the distinction between G-10 and Non G-10.

- Section 1(4), value of turnover: Formula for calculating turnover should be defined to order to allow consistency in the reporting. Turnover on money market instruments and derivative is usually not a relevant information as it is a direct consequence of the roll forward of short term positions. […] would suggests removing these from the reporting.

- Section 2(6): If the fund is distributed through intermediaries (for instance, retail funds, feeders, funds of funds…), this information will not necessarily be accessible and the AIFM might not be in a position to report.

- Section 3(9): AIFM should not be required to disclose ‘expected’ return and risk profiles to regulators. Such disclosure would be pure conjecture.

- Section 3(9): The category ‘infrastructure fund’ mentioned here is not included as a category per say under question 1. As this section focuses on typical ‘hedge fund’ risks, all fund categories other than hedge funds (for instance the unleveraged funds invested in listed securities as mentioned above) should be exempted from this section. Indeed, expected return cannot be assessed upfront for traditional funds taking long position on the markets as the return will largely derive from the beta.

- Section 3(c): Liquidity profile is not relevant for closed-end funds. They should be exempted from this reporting.

- Section 3(18) (i): If the fund is distributed through intermediaries (for instance, retail funds, funds sold through feeders, funds of funds, structures…), this information will not necessarily be accessible and the AIFM might not be in a position to report.

- Section 3(18)(i): The category 'other funds of funds' will mix up alternative and non-alternative strategies. Will this information be useful?

140. **ESMA's response:** With regards Section 1, ESMA decided to add a new point 2) with the breakdown of strategies. This section will allow, AIFM which are managing AIF falling into the bucket 'other' to give a description of the strategy pursued by the AIF. The section on geographical focus has been detailed with further breakdown by regions.

543. Under the section Individual Exposure (Section 4), as requested by respondents, a new line on cash and cash equivalent has been added as well as a reference to Money Market Funds under the heading Collective Investment Undertakings (Section4 paragraph d).

544. Concerning the paragraph on 'typical deal size', it was clarified that this information should be given only for private equity funds.

545. ESMA acknowledges that information on Investor Concentration might be difficult to obtain in certain circumstances but if AIFM has access to it, it should be communicated to competent authorities. Concerning the information on Controlling Influence, it has been restricted to private equity AIF.

546. For the section on liquidity profile, a new question asking whether or not the fund provides investors with withdrawal / redemption right has been added to take into account closed-ended funds that do not offer such possibility to investors. Finally, the question on fair value has been deleted.

141. Feedback on consultation on ESMA's draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive in relation to supervision and third countries (ESMA/2011/270)

142. Equivalence

143. Criteria

547. Many respondents sought clarification on the criteria and approach for the equivalence assessment (e.g. should it be a detailed comparison between the third country legislation and all relevant EU Directives, or only the AIFMD? Should the focus be on the 'outcomes' of the third country law, instead of a line-by-line comparison (equivalence meaning equivalent effects)?). Others challenged the concept of equivalence itself, since during the AIFMD negotiation this was discussed and dismissed. Several respondents advocated, alternatively, the use of international standards as the appropriate benchmarks (with reliance on IMF FSAP) and, more generally, a less prescriptive principles-based approach. The general suggestion was to issue transparent and

objective assessment criteria as soon as possible to allow third countries to make the necessary adjustments to their regulatory frameworks. More specifically, one respondent was of the view that the equivalence could cover ‘operating conditions’, since the AIFMD referred only to ‘prudential regulation and supervision’.

548. ESMA’s response: In light of the feedback to the consultation, ESMA considered it appropriate to replace references to ‘equivalence’ with ‘to the same effect’ in line with the Level 1 text. With respect to delegation of portfolio and risk management in particular, the notion of equivalence has been deleted entirely. This is in order to recognise the distinction at Level 1 between the requirements on third country depositaries, which explicitly envisage an assessment of the relevant regulatory framework, and those on delegation, which do not make provision for such an assessment.

144. Assessment process

549. According to some respondents, the implementing measures should provide for a clear methodology and procedure to assess equivalence. In order to avoid potential market disruption, the assessment should be conducted at the earliest possible opportunity and well before the commencement of the passport. For several respondents, ESMA should play a sufficient part in the overall process to ensure a level playing field. A dialogue with the relevant third country should be developed before any assessment.

550. ESMA’s response: ESMA did not consider it appropriate to enter into the details of the assessment of the third country framework at this stage, on the basis that this would more appropriately be addressed via other measures and that some flexibility should be retained. ESMA is also conscious of the concerns over the timing of the establishment of the co-operation arrangements and will treat this as a high priority in view of the July 2013 deadline.

145. Independence of the regulator

551. A question was raised on how compliance with the IOSCO/Basel Principles would be measured (e.g. self-assessment, ESMA review or IMF FSAP). One respondent pointed out that a regulator assessed as ‘broadly compliant’ should be deemed to satisfy the requirement (i.e. ‘full compliance’ should not be necessary). Another respondent maintained that this requirement of independence went beyond Level 1.

552. ESMA’s response: ESMA considers the independence of the regulator to be a crucial element when assessing the third country framework. Given its importance, ESMA maintains its view that ‘full compliance’ with the criteria set out in Part II (‘The Regulator’) of the IOSCO Objectives and Principles for Securities Regulation and relevant Methodology, and the Basel Committee Core Principles and the relevant Methodology, should be required.

146. Delegation

553. Some respondents suggested it be clarified that, consistently with Level 1, the requirement for authorisation/registration applies only when the delegated function relates to portfolio or risk management.

147. **ESMA's response:** ESMA agreed with the suggestion and has clarified this in the final advice.

148. Depositary

554. For several respondents the advice should clarify that an entity not licensed as a credit institution or an investment firm may still be subject to supervision and prudential requirements that satisfy the Directive. Moreover, it was considered essential that investment activity is not restricted while the Commission is deliberating on the equivalence. Some respondents felt that the advice should recognise that in some jurisdiction (e.g. the US) the supervision of portfolio custody can involve multiple authorities. A suggestion was also made to replace, in par. 7 of Box 2 explanatory text, the word 'may' with 'shall', in order clarify that the equivalence assessment has to be made by the Commission.

149. **ESMA's response:** ESMA has acknowledged in the final advice that an entity which is subject to prudential oversight and licensed under a local category other than as a credit institution or an investment firm may be assessed with a view to ascertaining whether the relevant local criteria have the same effect as those established under EU legislation for credit institutions and/or investment firms. ESMA has also made it clear that the Commission should (rather than 'may') issue decisions in this context.

150. Cooperation

151. On-site inspection

555. Concerns were raised in respect of allowing an EU competent authority to conduct its own regulatory inspections in a foreign country without qualifications; reciprocity should be ensured. According to one regulatory authority, a high frequency of on-site inspections on behalf of, and information exchanges with EU authorities, would result in significantly increased costs.

152. **ESMA's response:** ESMA has drafted its advice from the perspective of EU competent authorities and the rights that they should be granted on the basis of the co-operation agreements. The issue of possible reciprocity, if considered desirable by the third country authority, would be addressed during the discussions on the detailed content of the agreements.

153. Enforcement

556. Respondents requested more clarity on the respective responsibilities of the EU authorities and the third country regulators, since in their view a foreign regulator could not operate outside the remit of their national legislation and EU requirements could not apply outside the EU. It was stressed that the third country delegated entity and/or depositary applied local regulation on the assumption that the entity is regulated in its own jurisdiction; thus the enforcement should be only by the local regulator. Some respondents felt that the concepts of 'breach of regulation' and enforcement of 'EU legislation' were too broad and that the focus should rather be on breaches of the AIFMD.

154. **ESMA's response:** As noted above, the detailed allocation of responsibilities between the authorities will be addressed during the negotiation of the co-operation arrangements; the advice focuses on the key principles to be taken into account. ESMA agreed with respondents'

proposals for clarification and has amended the advice to make clear that the breaches should be understood as relating to the AIFMD and its implementing measures.

155. Cooperation arrangements

557. There was broad support for reliance on existing internationally agreed standards on enforcement and supervisory co-operation. Many respondents also expressed support for the proposed multilateral approach and for the role of ESMA in centralising negotiations. Some highlighted that bilateral MoUs should be permitted, but only until the ESMA MMoU was finalised. Others believed that Member State competent authorities should not be precluded from negotiating bilateral arrangements (e.g. in connection with private placement regimes under Article 42). Some noted that the scope of the co-operation arrangements set out in the CP (supervision and enforcement) would go beyond the AIFMD (systemic risk oversight). Some respondents suggested that the principles of proportionality and non-duplication should be introduced in the co-operation arrangements. It was further noted that the language used in Box 3 would seem to be inconsistent with the fact that regulators cannot enter into legally binding obligations. One respondent underlined the desirability of adopting a non-discriminatory approach to the extent that a difference in time of approval may unfairly advantage those jurisdictions considered first. In this respect some industry associations offered to help establish a list of countries where the conclusion of MoUs was more urgent. Finally, for the large majority of respondents, the safeguards applicable in the case of the third country passport should be fixed as soon as possible, and be the same as those in Box 3 (to ensure a level playing field).

156. **ESMA's response:** In light of the broad support expressed by respondents, ESMA has confirmed in the final advice its reliance on international standards. ESMA has also reiterated its preference for a centralised approach leading to the adoption of an MMoU covering all EU competent authorities. ESMA's aim is to finalise such an MMoU in good time ahead of the deadline of July 2013 and in a manner that ensures fair treatment of all third country authorities. Finally, ESMA considered whether to make a distinction between the information to be provided for the purposes of systemic risk oversight versus for supervision and enforcement purposes. ESMA is of the view that systemic risk is sufficiently important to justify the exchange of the same level of information in both cases.

157. Systemic risk oversight

558. Some respondents suggested that the information sharing should be provided upon request, instead of continuously and in respect of each and every fund marketed in the EU.

158. **ESMA's response:** ESMA did not consider it appropriate to limit the information sharing to ad-hoc requests only on the basis that systemic risks could arise quickly and could be monitored more effectively if information was provided on a more regular basis.

159. Data protection

559. Some respondents raised concerns on par. 7 of the explanatory text under Box 3, as they felt it required that the third country regulator would ensure an adequate level of data protection within the meaning of Directive 95/46/EC, which would go beyond Article 52 of the AIFMD.

160. **ESMA's response:** In the final advice, ESMA has modified the relevant text so as to align it more closely with the requirements in Articles 51 and 52 of the AIFMD. ESMA is not seeking to go beyond the provisions on data protection as set out in those articles.

161. <u>Cross-border marketing</u>

162. <u>Definition of effective marketing</u>

560. While supporting ESMA's approach, several respondents sought guidance on the criteria to determine where effective marketing of most of the AIFs is conducted (e.g. number of investor targeted, frequency and visibility of advertisement, amount of assets raised). A list of non-exhaustive factors was generally deemed useful. It was noted that if the reference is to the majority of investors (number or value of investments), this figure would change over time; the criteria could rather refer to the presence of affiliates/distributors.

163. **ESMA's response:** ESMA agreed with the need to expand on the criteria to be taken into account when determining where the effective marketing of most of the AIFs takes place. These indicative criteria have been included in the revised explanatory text.

164. <u>Procedural concerns</u>

561. One respondent suggested the introduction of a non-objection procedure to the effect that the Member State of reference should automatically be the one designated by the AIFM unless reasoned objection is notified in writing by the relevant regulator within one month.

165. **ESMA's response:** ESMA took the view that such an approach would leave too much discretion for the AIFM and did not give sufficient recognition to the role of the competent authority in determining the Member State of reference.