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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€

[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 London 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 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 stakeholders 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: http://www.esma.europa.eu/page/AIFMD; summaries prepared by ESMA can be found in 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.

[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 consistent ways 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".

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

[14] The management of the Luxalpha fund (a UCITS compliant fund) was delegated by its management company, UBS, 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 Luxalpha incurred significant asset losses. In subsequent law suits, various EU jurisdictions have assessed the liability of the depositary in materially 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,

[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

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

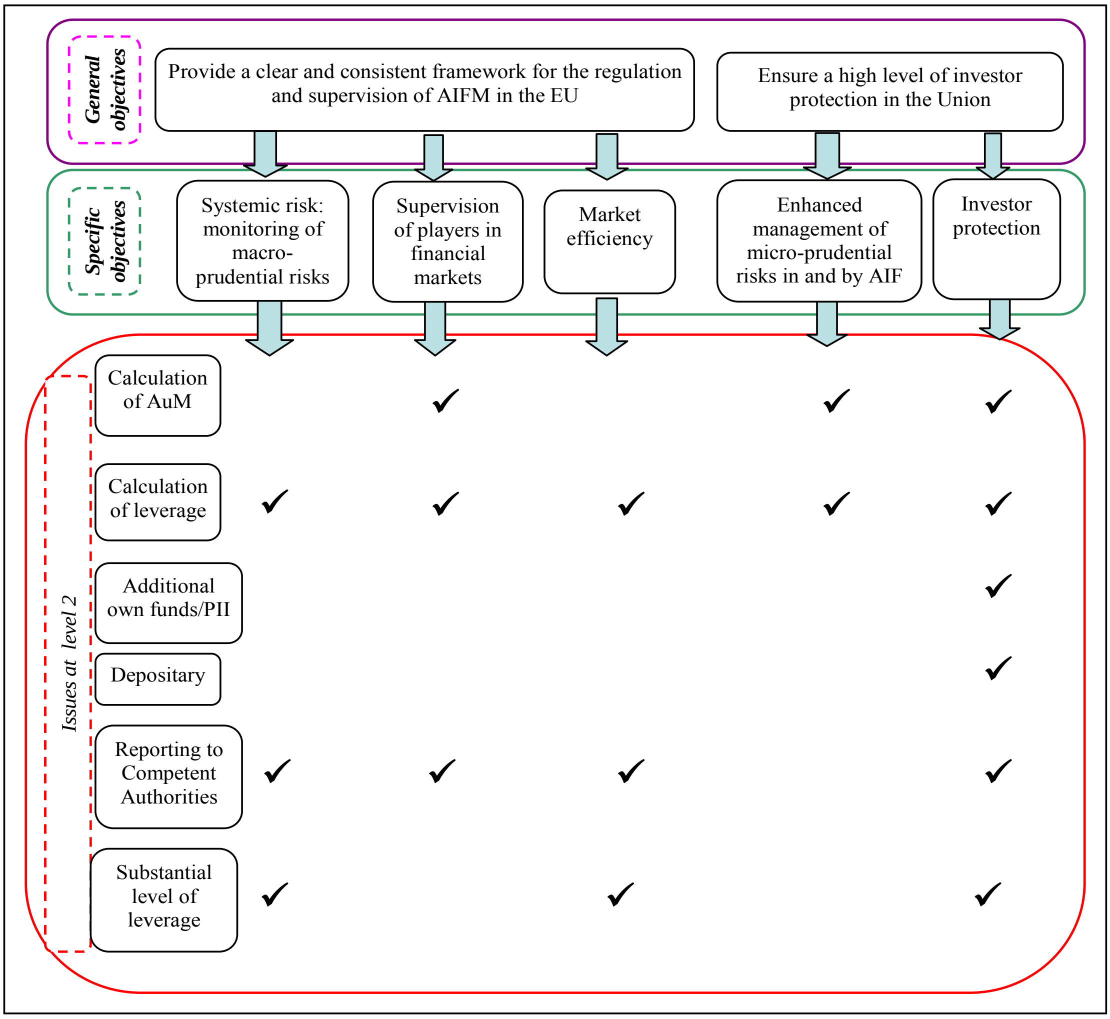
With respect to the implementing measures, additional operational objectives, which derive from the above can be defined:

- Issue 1, Calculation of the AuM: 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, Calculation of leverage: 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, Additional own funds/PII: 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, Depositary: 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, Reporting to Competent Authorities: 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, Leverage employed on a substantial basis: 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


General objectives
Provide a clear and consistent framework for the regulation and supervision of AIFM in the EU
Ensure a high level of investor protection in the Union
Specific objectives
Issues at level 2

	Systemic risk: monitoring of macro-prudential risks	Supervision of players in financial markets	Market efficiency	Enhanced management of micro-prudential risks in and by AIF	Investor protection
Calculation of AuM		✓		✓	✓
Calculation of leverage	✓	✓	✓	✓	✓
Additional own funds/PII					✓
Depositary					✓
Reporting to Competent Authorities	✓	✓	✓		✓
Substantial level of leverage	✓		✓		✓

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:

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

Option 2 (NAV): 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.

Option 3 (Total AuM using market value of FDI): 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]

[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

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.

Option 3 (Gross method): 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]

Option 4 (Commitment method): 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.

Option 5 (2 methods): 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.

[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'.

Option 4 (Commitment approach): 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 hedge funds and 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 types 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	Efficiency
	Investor protection	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

[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 all 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.

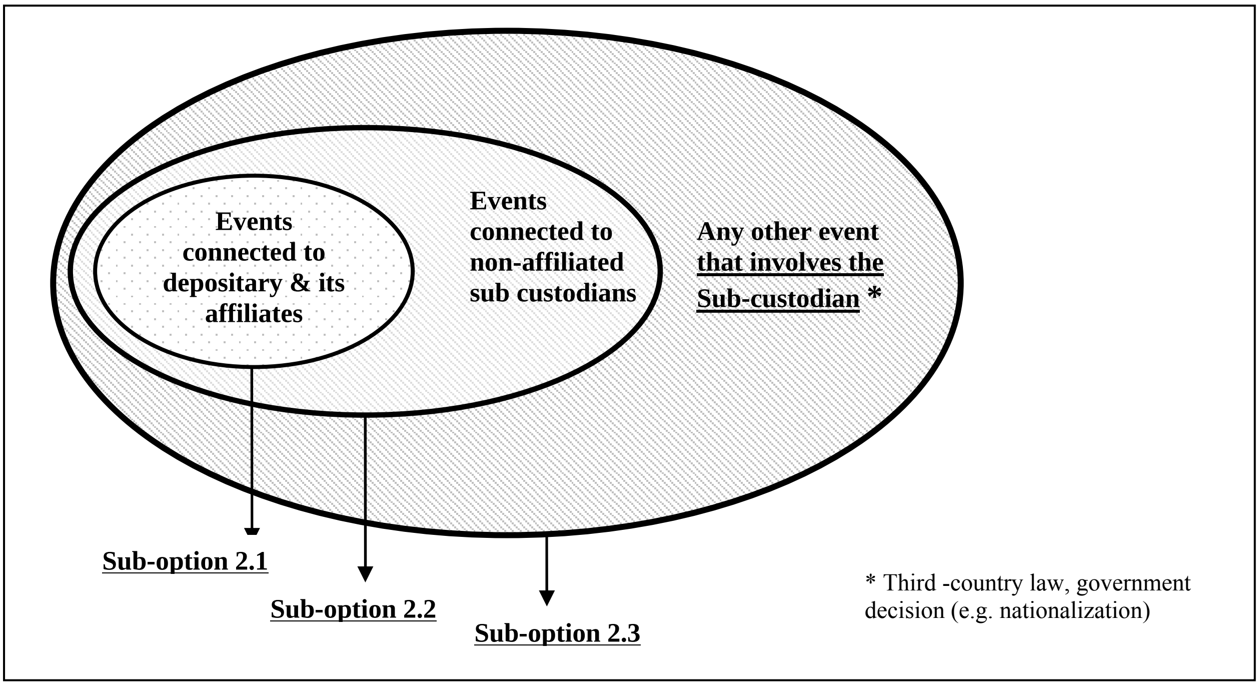
The AIFMD also aims to ensure that a delegation of tasks to a third party, the sub-custodian, shall not affect the depositary's duty to either return a financial instrument of identical type or to pay the corresponding amount to the AIF.

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"


Events connected to depositary & its affiliates
Events connected to non-affiliated sub custodians
Any other event that involves the Sub-custodian *
Sub-option 2.1
Sub-option 2.2
Sub-option 2.3
* Third -country law, government decision (e.g. nationalization)

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 appears to be the principle 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 obviously 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 industryas 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 not 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:

- 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.

Option 4 (Level of activity): 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.

Option 5 (Size and investment type): 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

[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. EFAMA, AIMA, IMA and ABI.

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, the UK Investment Management Association (IMA) estimates 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.

IMA 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]

BaFin, the German supervisor, 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.

[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 estimates than as proper, representative calculations.

Comparison of options

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 law and regulation.

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 London 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

o **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.

o 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. The loss of 2 billion USD that suffered UBS last year is an example of an operational risk, namely the 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 the fund, however, might be understood as a sign of weakness or incompetence while staying in the

[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

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.

o **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

	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
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

Calculation by the French Competent Authority, AMF, 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.

- **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

- 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.

- Specifying how leverage shall be calculated:

Assessment of IA need

Dealt with in detail in the body of the IA report

- **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

- 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.

- **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].

- **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)

o **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.

o **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:

- 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

- 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.

- 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

- **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.

o **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.

o **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:

EU AIFM managing non-EU AIF which are not marketed in Member States: 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.

EU AIFM marketing non-EU AIF in Member States without a passport: 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.

Non-EU AIFM marketing EU or non-EU AIF in Member States without a passport: 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:

EU AIFM marketing non-EU AIF with passport in the EU: 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.

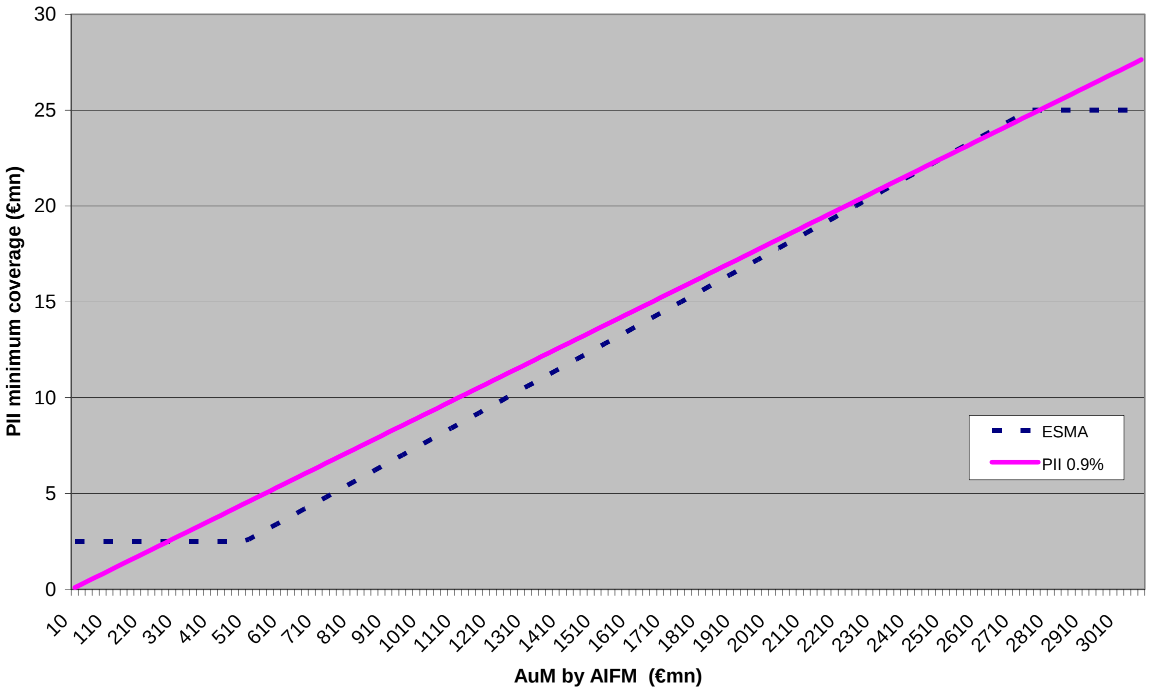
The absolute minimum amount might make sense if there were not the additional own funds of Article 9(3) AIFMD already. But as they already exist, this minimum would put a relatively higher burden on AIFM managing portfolios up to €500 million. Furthermore, it would be particularly burdensome for small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

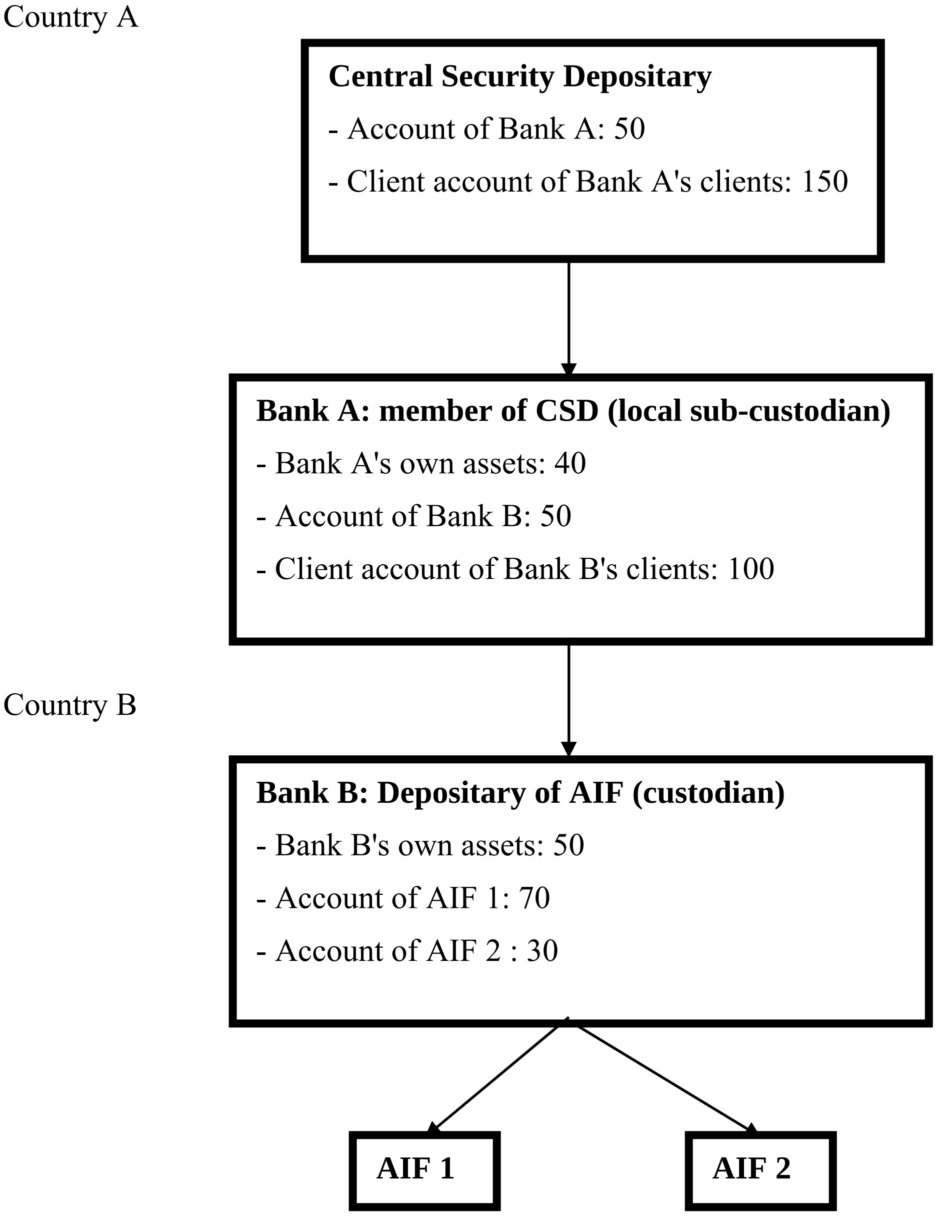
It therefore seems to be more appropriate to align the multiplier for PII with the one for additional own funds, i.e. to apply a factor without any thresholds or caps. As suppressing threshold and cap would result in significantly higher coverage the factors can be reduced to 0,9% instead of 1% of AuM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



Country A

Central Security Depositary

- Account of Bank A: 50
- Client account of Bank A's clients: 150

Bank A: member of CSD (local sub-custodian)

- Bank A's own assets: 40
- Account of Bank B: 50
- Client account of Bank B's clients: 100

Country B

Bank B: Depositary of AIF (custodian)

- Bank B's own assets: 50
- Account of AIF 1: 70
- Account of AIF 2 : 30

AIF 1

AIF 2

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: Summary of ESMA public consultation on AIFMD advice

This Annex presents relevant excerpts from a longer summary that had been prepared by ESMA staff.

1. ESMA received 104 responses to the consultation on the draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive (AIFMD). Responses were received from alternative investment fund managers (and their associations), depositaries (and their associations) and institutional investors.

Article 3 Exemptions

General comments

2. EVCA and EFAMA 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. Both associations also agreed that AIFM should exclude from the assets under management calculation crossholdings in other AIFs managed by the same AIFM.

Calculation of leverage

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?

3. In general, this proposal was not supported by respondents to the consultation.
4. For EVCA it was difficult to understand why for the purpose of calculating the AuM, the leverage should computed using the gross method. According to the trade association, the mere concept of taking gross exposure did not seem to fit very well with a calculation of asset under management which is generally proposed to be made on a net basis, and they believed it may produce inappropriate results. Also, EVCA asked for clarification whether the policy intention was to substitute gross exposure for NAV whenever the former exceeds the latter. If it was the intention, EVCA would disagree with this approach.
5. IFIA and AIMA also disagreed with the proposition to include the gross exposure in the calculation of the value of assets under management because the NAV already includes the value of instruments acquired through leverage.
6. EFAMA disagreed with this proposal and called for consistent approach throughout the Level 2 measures.
7. AIC agreed with this proposal but did not provide further detail and justification.
8. According to a trade association, including gross leverage would be misleading because investors and industry participants have a clear understanding of the term AUM 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.

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?

9. A majority of respondents to the consultation (EVCA, EFAMA, AIMA, IMA, ABI, VAI, VGF and AIC) were in favour of this proposal. For IFIA and ALFI, 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.

Do you consider that the proposed requirements for calculating the total value of assets under management are clear? Will this approach produce accurate results?

10. EVCA generally felt the proposed requirements for calculating the total value of asset under management clear but reiterated its position concerning the gross exposure which, according the trade association was a different concept from the total value of asset under management.
11. EFAMA considered that the proposed requirements for calculating the total value of assets under management were clear.
12. Except the use of the gross method for assets acquired through leverage, AIMA felt the process for calculating the AuM clear.

13. AIC felt the proposed requirements clear.

14. IMA proposed to include in the line 1 of paragraph 3 the words 'as manages the investing AIF' after the words 'the same externally appointed AIFM'. It was also IMA and ABI understanding that it was not necessarily to look through the underlying funds when calculating the leverage. Finally, IMA and ABI felt paragraph 5 far too prescriptive and disagreed with the 3-month period and propose a 12-month period instead (to wait until the next calculation).

15. VAI did not feel the requirements clear enough because of the variety of AIFs which makes the use of the NAV not appropriate in all cases.

16. For VGF, ESMA should specify that for AIFM investing in physical assets, different methodology could be used as the income value approach for instance.

IV.I. Possible Implementing Measures on Additional Own Funds and Professional Indemnity Insurance

General comments

17. EFAMA 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 (EVCA too asked for some tailoring for internally managed AIFs) and raised a number of practical questions:

- it is unclear how the additional own funds should be raised;
- it is 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 is unclear how they should raise the additional own funds or adjust them during their life.

18. EFAMA 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.

19. In addition, EFAMA called for the introduction of (i) a cap on the additional own funds reflecting the EUR 10 million's cap for the own funds, (ii) the possibility for AIFM to use a combination of additional own funds and PII and (iii) some proportionality for 'UCITS-like funds' which may risk to become overcapitalised in relation to potential liability risks resulting from their operational activities.

20. ABI 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.

21. CEA mentioned that the few insurers available in this market indicated that 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, CEA 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.

Quantitative Requirements

22. EFAMA called for the introduction of a cap on the additional own funds reflecting the EUR 10 million's cap for the own funds. BPF supported the idea of introducing a cap and suggested to set it at EUR 1 million.

23. EFAMA (majority of members), EVCA, INREV, VGF and BPF preferred option 1 under Box 8. EFAMA (majority of members) mentioned that there is no logical link between the liability risk and the income of an AIFM foreseen under option 2. EFAMA explained that option 2 is more complicated and leaves wide room for diverging interpretations by the different competent authorities, in particular in relation to the 'relevant income', which is also difficult and cumbersome to determine in practice. INREV mentioned that it should be guaranteed that the liability risk of 0,01% remains fixed and should not be increased over time. VGF mentioned 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.

24. BPF preferred option 2 under Box 8, which would be likely to result in lower requirements for its members.

25. AIC recommended that both option 1 and option 2 should be made available to an AIFM and, in case only one of the two options is to be made available, it recommended that option 1, which represents a simple and clear requirement, should be retained.

26. EVCA 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. EFAMA asked for significantly lowering the quantitative requirements for both options; indeed, in both cases, the requirements seemed very high compared to historical loss data.

27. EVCA 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 (amended wording for paragraph 2 of Box 8 is proposed in the EVCA's submission).

28. EFAMA (majority of members) and AIC considered that national competent authorities shall have the power to lower the additional own funds requirements. INREV was of the opinion that this could lead to regulatory arbitrage and market distortions between member states and one member of EFAMA considered that such solution is not appropriate and the power should be exercised by ESMA.

29. EPRA and BPF mentioned that it was difficult to understand what the insurable interest to which a PII could relate is for a listed property company since the latter does not generally owe duties to its shareholders; they added that, to the extent that a property company does not have income comparable to the income of an AIFM from its externally managed AIF, it was not clear how its relevant income should be calculated for the purposes of option 1 under Box 8.

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.

30. EVCA provided empirical evidence (page 26 of EVCA's submission) showing that option 2 would result in a significantly higher requirement.

31. VGF mentioned that option 1 would imply a further EUR 17.15 million in additional own funds for existing non-tradable closed-ended funds (which are excluded from the scope of the AIFMD, according to its article 61(3)); no statistical data for option 2 are available and estimates are impossible to make mainly because there is no clear definition of the term 'income'.

32. INREV mentioned that it did not have empirical evidence, but that it appeared that the incidence of such claims in the non-listed real estate funds industry is infrequent.

Depositaries

General comments

33. There was some support 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 (INREV, EPRA, VGF).

34. Several respondents stressed their preference for an approach based on ex-post controls (EBF), particularly with regards to oversight of 'other assets' ((BPF, VGF, AIC).

35. EVCA noted that 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.

36. EBF called for the AIFMD and UCITS requirements on oversight duties to be aligned.

37. Euroclear 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.

38. Looking at the impact of the requirements, AIMA 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. This issue was addressed further in the detailed CBA AIMA provided. EVCA 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 ETDF and AGC considered that the proposals would effectively make depositaries insurers of the fund industry.

Duties of the depositary

General comments

39. EVCA felt that a number of references in the explanatory text overstated the depositary's duties as set out in L1 e.g. oversight of 'applicable law and regulation', which in their view was too broad.

Depositary functions

Depositary functions pursuant to §7 – Cash monitoring

Cash flow monitoring

40. AFME PBC and EFAMA broadly supported the proposals but made a few remarks.

41. On the second bullet point, EFAMA 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). AGC 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.

42. On the third bullet point, EFAMA 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, BPF and INREV favoured limiting the obligation to 'material' information in order not to capture very small payments, which were likely to be common for RE funds, while ABI favoured restricting to 'necessary' information. More generally, EBF 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.

43. EFAMA, EVCA 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 when the AIFM may not have all the necessary information and the reference to Article 21 of the Directive was too broad. EFAMA, EVCA therefore favoured deletion of the sentence, or at least clarification of the scope of the AIFM's obligations.

44. AIMA (see specific drafting suggestions) 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.

45. ETDF 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.

46. EVCA proposed a change to cover situations where the depositary opens an account in its name but grants the AIFM a mandate over the account, in which case the parties need to arrange for the depositary to receive the same information as if the account were opened in the name of the AIF.

47. BPF sought confirmation that the cash flow monitoring duties covered only the accounts of the AIF rather than the real estate operating and investment businesses of the companies, partnerships etc invested in.

48. INREV 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.

49. INREV 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.

50. INREV 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 L1 and, given the large number of small operational cash flows in RE funds, it was more appropriate to limit to subscriptions and redemptions.

51. AFME PBC requested confirmation that the information required by Box 75, particularly the third bullet point, should be provided on an ex-post basis.

Proper monitoring of all AIF's cash flows

52. AIMA (see specific drafting suggestions), EFAMA, EVCA, ETDF, BPF, INREV, EPRA, VGF, AIC, AGC, AFME PBC, EACB, ABI had a clear preference for option 2 on the basis that:

- The requirement in option 1 to mirror transactions would be very expensive and duplicate the work of fund administrators (EFAMA, ETDF).
- 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 (EVCA).
- 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 (ETDF, EBF).
- Explanatory-ante controls would interfere with the fundamental relationship between investor and manager (EBF – but see comments below on option 1).
- The depositary should be responsible for secondary level controls only (ETDF) and the importance of the first level of controls should be reaffirmed (EBF).
- 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 (INREV).
- 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 (VGF).
- Option 1 would inappropriately restrict distribution options (EBF).
- 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 (AIC).
- 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 (AIC).
- Option 1 would be operationally challenging, costly and divert the depositary's attention from meaningful oversight and supervision (AGC).
- 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 (AFME PBC).
- Option 1 would relieve the AIFM of its duty to properly monitor its cash flows and shift the liability towards the depositary (EACB).
- 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 (ABI).
- The monitoring required by option 2 would be sufficient to ensure a proper monitoring of all AIF's cash flows (ABI).

53. EBF 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, EBF 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.

54. Regarding the detail of option 2, AIMA 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. AIMA 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.

55. EFAMA, ETDF, EBF noted that the reference in the CP (paragraph 9 on p.150) to weekly verifications by the depositary for funds performing reconciliations on a daily basis did not reflect current market practice and should therefore be deleted. On the same point, EACB believed that the verification frequency should be tailored to the nature, scale and complexity of the AIF or volume of transactions rather than the reconciliation frequency. The same respondent felt that 'full review of the reconciliation process' needed to be more accurately defined.

56. More generally, EVCA felt that the depositary should be able to rely on work done by third parties such as auditors and suggested four criteria that would have to be satisfied for such reliance to be permitted (independence, competence, existence of terms of engagement and absence of any other circumstances rendering such reliance inappropriate).

57. INREV agreed with ESMA's proposals on the reconciliation process for subscriptions and redemptions.

58. Notwithstanding the broad support for option 2, the following specific comments/amendments were proposed:

Paragraph 1

- 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 (EBF).

Paragraph 2

- The reference should be to reconciling cash **balances** (EVCA).
- The proper procedures should be **at the AIFM** (EBF).

Paragraph 3

- Primary responsibility for identifying any inconsistent transactions lies with the AIFM (ETDF).
- The appropriate procedures should be **at the AIFM** (EBF).

Paragraph 4

- The depositary should check that the relevant cash accounts opened in the name of the AIF are included in the reconciliation process (EBF).

Paragraph 5

- Clarify by adding a reference to '**any discrepancies identified by the reconciliation** procedures' (EVCA).

59. INREV noted that for RE funds investing directly in real property, it may be necessary, following receipt of cash for the AIF and its booking into an account of the AIF, for payments to be made out to property managers, lawyers or others in advance of expenses to be discharged by them or the completion of a transaction. INREV also referred to its Business Impact Analysis on the two options.

60. AFME PBC sought clarification that the provisions of Article 21(7) permitted the holding of cash by a prime broker even where that prime broker was not a credit institution.

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?

61. AIMA, EFAMA, ETDF, BPF, INREV, VGF, EBF, AIC, AGC, AFME PBC, EACB, ABI 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 L1 of such a provision. AFME PBC added that most AIFs/AIFMs would need to be able to hold cash with their prime brokers or other parties in order to meet their DVP settlement obligations or for general trading activity.

62. EFAMA, VGF, EBF, AFME PBC, EACB, ABI added that such a requirement was not in line with current market practice (e.g. for real estate funds). ETDF, EACB felt it would be detrimental to the AIF and ultimately investors due to the adverse impact on distribution channels and increased costs. ABI explained that it was currently common practice for the transfer agent/registrar of the AIF to receive/pay out monies in respect of subscriptions and redemptions of units/shares in the AIF and duly record and account to the AIF/AIFM for those transactions.

63. EFAMA recognised potential advantages of such a requirement (e.g. by increasing the depositary's ability to monitor the settlement process) but felt that these would be outweighed by disadvantages such as the adverse impact on distribution channels. EFAMA added that not all depositaries had the operational or regulatory capability to operate such accounts.

64. EVCA explained that most PE/VC funds did not operate separate sub-red and general operating accounts and that it would add no value to require such a practice. BPF made a similar point for RE funds.

65. INREV felt it would be possible for the sub-red account to be opened at the depositary (where the depositary is a bank) but considered it operationally impossible for the general operating account.

Ensuring the AIF's cash is properly booked

66. EFAMA, ETDF supported the requirements. Other respondents made the following specific comments.

Paragraph 1

- Replace 'AIFM complies' with 'AIF, or AIFM has appropriate procedures in place ensuring its compliance' (AIMA)
- 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 (AGC). AGC explained that, where cash is booked with a third party as a deposit, the third party 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.

Paragraph 2

- Insert after the word 'ensure' the words 'that the AIF or AIFM has appropriate procedures in place to ensure that' (AIMA).
- Delete the references to 'compelled' and 'investment decision', replace with concept of 'interests of the AIF' (AGC) 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.

67. EVCA felt that reference to compliance with Article 16 of the MiFID L2 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.

68. On a more general point, AFME PBC was concerned that the requirement that '…the AIFs' cash is booked in one or more cash accounts distinct from the accounts where the cash belonging to the depositary or belonging to the third party are booked' did not properly reflect the debtor/creditor nature of bank accounts or scenarios where the CSD cash account is a single account in the name of the sub-custodian. AFME PBC added that some national regimes, such as the UK FSA's Client Money Rules,

required the use of omnibus accounts opened in the name of the financial institution for unnamed clients rather than in the name of the AIF/AIFM, and saw a risk that such regimes would be undermined by the proposed advice.

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?

69. While stressing that it was difficult to generalise due to the diversity of AIFs, EFAMA explained that for open-ended AIFs trading on a daily basis, daily reconciliation of cash flows for subscription and redemptions was standard (also AIMA, ABI) while for operating accounts monthly or quarterly reconciliation was the norm. EFAMA also noted that the frequency depended more on the valuation frequency and/or the impact of cash collateral arrangements.

70. EVCA considered that for PE/VC funds, cash reconciliation should only be required on an event-driven basis or semi-annually.

71. ETDF was not in favour of a pre-established frequency for the investment cycle as this depended on the nature, scale and complexity of the fund, while for the shareholder cycle the frequency depended on the nature and frequency of dealing. Similarly, VGF, EACB were against setting specific frequencies and called for flexibility. VGF noted that for non-tradeable closed-end funds the cash flows were only significant at the beginning and thereafter consisted only of payments to investors on a quarterly or annual basis.

72. INREV note that in general, reconciliations of cash flows for subscriptions and redemptions were performed by depositaries daily or at such frequency as subscriptions and redemptions occur in the relevant fund, while reconciliations of cash flows for operating accounts were generally performed by depositaries monthly or quarterly on a ex-post basis, although they could also occur at different intervals.

73. EBF, EACB explained that reconciliation of cash flows was performed at each calculation of the NAV by the AIF as the administrator/valuer, and that the depositary verified this reconciliation on a periodic basis.

74. AIC explained that most investment companies reconciled their cash positions on at least a monthly basis but that many reconciled daily. AIC also noted that as closed-ended funds, these entities did not have to cater for regular subscriptions and redemptions of shares.

75. AGC identified three levels of reconciliation: i) reconciliations conducted by the depositary/ AIFM/administrator between its records and the external financial institution where the AIF holds an account; and ii) reconciliations conducted between the depositary and its correspondent financial institutions for cash accounts opened with correspondents in the depositary's name for the AIF; and iii) reconciliations between the depositary and other entities holding cash in the chain of distribution. In the first case, AGC believed the frequency should be proportionate to the type of activity, trading frequency and movement volumes (with daily frequency appropriate for high volumes). In the second case, full daily reconciliation was appropriate. In the third case, reconciliations should be aligned with trading frequency. AGC added that when reconciliations were performed by a third party, the depositary should verify the application of procedures by the third party on a monthly basis.

76. AFME PBC explained that most reconciliations were performed on a daily basis, ex post.

77. For ABI, the determining factors were the frequency of valuation of the assets and of the NAV calculation, which would themselves depend on the types of underlying asset and the frequency of dealing in units/shares by investors.

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

78. EFAMA, ETDF, BPF, VGF, EBF, AIC, AGC, EACB, ABI did not anticipate any practical problems, while AIMA cross-referred to its comments under Box 75 i.e. that the obligation should apply at the 'head' level.

79. EVCA reiterated its view that a cross-reference to MiFID was not appropriate (and that the reference should be to Article 16 of MiFID L2 in any case).

80. INREV called for flexibility to allow ongoing transactional and operational payments to be booked to entities other than those set out in Article 18 of MiFID L2 e.g. lawyers.

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

81. EFAMA, AIMA, ETDF, AGC, ABI foresaw no particular difficulties provided option 2 in Box 76 was adopted. In this context, EFAMA, ETDF, EBF, EACB 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. EBF and EACB 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 (EBF) 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.

82. VGF noted that non-tradeable closed-end funds did not use prime brokers.

83. EBF was of the view that only cash held as ordinary deposits with the prime broker should fall within the scope of the depositary's recordkeeping duties.

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

84. EFAMA, ETDF, INREV, VGF, AIC, AGC, EACB 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. AIMA estimated the increase in running costs to be between 30-100% (on top of additional costs for building new systems), while EVCA estimated an increase of 5-10 basis points for basic services and up to 20 basis points if the depositary provides other services.

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

85. ETDF, AGC, EACB, ABI 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. ABI 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. EBF also expected the costs in terms of infrastructure and resources to be very high.

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

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

86. EFAMA (large majority of members) and AFME PBC agreed with the proposed treatment of transferable securities, money market instruments and units of CIUs.

87. Euroclear supported option 1. In their view option 2 would not be workable in practice for the following reasons:

- Not all CSDs offer title transfer on their books. This is the case e.g. for Euroclear France. Option 2 would therefore be meaningless for e.g. French securities.
- Some assets, which are generally considered to be in custody, are not held in a CSD. For example, UCITS securities are not always deposited in CSDs. As a consequence, Option 2 would reduce the group of assets covered by the AIFMD requirements.
- Option 2 would require the AIFM to know which securities are ultimately held or settled in CSDs and which ones are not. This information is not always readily available to the AIFM or even its depositary.
- In addition, the AIFM would need to be transparent towards its investors about the different liability regime that applies to certain securities (i.e. those not deposited into a CSD), and this information would need to be available for each security held by the AIF.

88. EFAMA members had mixed views on the options. Some EFAMA members felt that both options inappropriately narrowed the scope of the depositary's duties as set out at Level 1. These members 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). These members 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 these members, 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.

89. Similarly, ABI felt that either option would narrow the scope of the depositary provisions in a way that was not intended at L1. In line with some EFAMA members, they considered that option 1 left the possibility open for the depositary to structure the manner in which it holds financial instruments to avoid the provisions of the Directive. Similarly, ABI felt that option 2 would exclude certain financial instruments, particularly in countries such as Russia. ABI therefore preferred an approach whereby the depositary would 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’.

90. There was significant support for option 2, including from other EFAMA members for the reasons set out by ESMA in the CP. AIMA strongly supported option 2 and believed the definition should be limited to three criteria: i) transferable securities, money market instruments and CIUs should be captured; ii) all instruments provided as collateral should be excluded; and iii) the depositary must be able to instruct the transfer of title (or an interest therein) by means of a book-entry on the register maintained by a settlement system designated under the Settlement Finality Directive or a similar non-European settlement system (i.e. Option 2 in Box 78). In AIMA’s view, 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.

91. EVCA supported option 2 subject to amendments (deletion of ‘which acts…or its agent’, deletion of reference to physical delivery). ETDF, EBF also 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. EBF supported option 2 provided that it was understood that the financial instruments are held in custody by the depositary within its sub-custody network.

92. BPF supported option 2 on the basis that option 1 was unclear, particularly for RE assets; in BPF’s 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.

93. AIC supported option 2.

94. AGC supported option 2 (see detailed comments on a contrario approach and distinction between situations where the depositary is the participant in the settlement system – such assets should be held in custody – and where the financial instruments are merely ‘registered in the nominee name’ of the depositary or its subsidiary nominee company – such assets should not be held in custody).

95. AFME PBC 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.

96. EACB 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.

97. EFAMA 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.

98. AIMA, BPF felt 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, EBF 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 AGC favoured a reference to financial instruments which have been physically delivered (see other drafting suggestions re bearer instruments and security interests).

99. VGF sought confirmation that limited commercial partnerships and shares in such partnerships did not fall in the scope of assets to be held in custody.

100. AFME PBC 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. They proposed the following revised text:

101. 'Further, for financial instruments which comply with the definition set out above, if a depositary has exercised its right of re-use of such financial instruments, it shall still be required to ensure return of such financial instruments to the AIF as if they had been held in custody.'

102. AFME PBC also sought clarification on the meaning of the term 'temporary lending agreement' and suggested that 'lending agreement' should be sufficient. AFME PBC explained that in many jurisdictions, lending arrangements involved the full title transfer of financial instruments; while in such cases the assets could no longer be held in custody, the lender only had a contractual right to redelivery of equivalent securities and therefore the 'other asset' was this contractual right rather than any residual ownership in the financial instruments 'lent'.

103. AFME PBC felt that assets held by a sub-custodian should be held in custody even if that sub-custodian had a lien (on the basis that the depositary retained control).

104. AIME 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).

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?

105. ETDF, EACB identified transferable securities, money market instruments and units of CIUs while ETDF 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 – see also AGC).

106. BPF 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. They are also entitled to have a mandate over the cash accounts of the funds.

107. EBF 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.

108. Euroclear 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.

109. ABI 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.

110. EVCA noted that PE/VC funds typically did not use custodians because of the nature of the assets held.

Treatment of collateral – Article 21 (8) (a)

111. ETDF, EBF supported option 2 on the basis that it provided the necessary flexibility (see also ETDF drafting suggestion for first sentence of Box 79).

112. EFAMA (large majority of members), AIMA (see variant proposed), AIC, AGC (see suggested clarification), AFME PBC, ABI considered option 3 to be the most appropriate as 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 (AGC).

113. AFME PBC, ABI suggested widening the scope of option 3 to cover collateral arrangements which are not financial collateral arrangements (as defined) in order to allow greater certainty over equivalent arrangements existing outside the EU (AFME PBC). AFME PBC 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, AFME PBC 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.

114. AIMA, EVCA, ABI supported the use of cross-references to the Financial Collateral Directive (FCD) while stressing that there should be no requirement for collateral arrangements used by AIFs to be subject to the FCD before they can be considered as collateral. EVCA proposed adding wording to cover all situations in which the collateral is under the control of the collateral taker.

115. EFAMA, ABI 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).

116. ABI 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.

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?

117. EFAMA, EACB explained that 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. EFAMA did not see the relevance of the distinction made in option 2 in this context while EACB supported option 2 as the most appropriate for all circumstances.

118. ETDF saw no need for further clarification. In their view, financial instruments provided as collateral did not qualify for custody unless:

- they have not been transferred out of the depositary’s book;
- the ownership rights have not been transferred to a third party; and
- they cannot be re-hypothecated by a third party which is not the depositary.

119. AGC explained the 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. AFME PBC and ABI were was of a similar view, noting that the distinction should normally be clear on the basis of the documentation.

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?

120. EFAMA 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.

121. AIMA 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). ABI took a similar view.

122. EVCA considered this notion to be irrelevant to PE/VC funds due to the unique nature of the investments and the existence of transfer restrictions.

123. ETDF, INREV 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. ETDF, INREV, AGC favoured an approach which would allow all three models to continue.

124. EACB 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.

125. VGF 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.

126. AGC stressed that registering in a nominee name did not in itself suggest the asset is held in custody.

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?

127. EFAMA, EVCA, ETDF, INREV, AIC, AGC, EACB, ABI 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.

128. AIMA reiterated its arguments in favour of option 1.

129. VGF felt that option 2 might involve lower costs as it involved fewer requirements on the depositary but was not able to state this conclusively.

130. AFME PBC 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.

The depositary’s liability regime

Loss of financial instruments

External events beyond reasonable control

Definition of ‘external event beyond the depositary’s reasonable control, the consequences of which were unavoidable despite all reasonable efforts to the contrary’

131. EFAMA members were split on the proposal. Some members 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. Other EFAMA members, AFME PBC, EACB, ABI (see also comments on Box 89) 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 EFAMA members, namely that paragraph 1 could be restricted to cover acts and omissions of sub-custodians that are affiliates of the depositary.

132. AIMA was 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 (de facto amendment of L1, increased capital costs leading to increased fees leading to lower returns). ETDF, EBF, AFME PBC, EACB took a similar view. AIMA could, however, envisage considering events at affiliated sub-custodians as 'internal'. EVCA broadly agreed with AIMA, arguing that events in relation to sub-custodians could be external in some cases. EVCA also favoured an explicit statement that loss of an investment due to investment risks is not the responsibility of the depositary.

133. Euroclear 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.

Paragraph 1

- ETDF, AGC felt that only improper acts or failures of the depositary should be captured. AGC added that the obligations referred to should be limited to those set out in the Directive. ABI favoured restricting the scope to acts or omissions of affiliates of the depositary (affiliates to be interpreted broadly), provided their comments on 'financial instruments' and 'loss' were taken into account.

Paragraph 3

- ETDF, AGC, EBF felt that there should be a reference to 'reasonable efforts' instead of 'rigorous and comprehensive due diligence'.
- AIC, ABI favoured deletion/clarification on the basis that this overlapped with the responsibilities of the AIFM as required by Article 8(1)(c) of the Directive.

Paragraph 3(a)

- AGC 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 ('and not with the expenditure of limitless resources in order to 'ferret out' that which cannot be reasonably anticipated').

Paragraph 3(c)

- AGC 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.

Paragraph 26 of Explanatory text

- ETDF – replace 'appear' by 'are'.

Paragraph 29

- ETDF disagreed as they felt that fraud at a sub-custodian should be considered external provided the depositary has satisfied the due diligence requirements. AGC took a similar view, noting that it amounted to imposing strict liability on depositaries.

Paragraph 34

- ETDF, AGC – the last sentence relates more to the 'reasonable efforts' section.

Paragraph 37

- ETDF, AGC – the last sentence should be deleted as it contradicts the rest of the paragraph.

Paragraphs 38 & 39

- EFAMA (some members), ETDF, AGC, AFME PBC expressed concerns about the proposal set out in paragraphs 38 and 39 under Box 91 on the basis that: it was not realistic and too long

(EFAMA); it did not strike the balance that ESMA was seeking (ETDF); it could create legal uncertainty in times of crisis (ETDF, AFME PBC); the depositary should not be expected to carry out a quasi-investment management function (AFME PBC); the depositary would not necessarily know the identity of the investors (AFME PBC). ETDF, AGC added that where the depositary has made a notification to the CA, it should be discharged of liability for any resulting loss; ETDF identified the possibility of placing a requirement on the depositary to review the situation periodically and even the introduction of a sunset clause. ETDF, AGC also suggested requiring AIFMs to cover this in the pre-investment disclosures to investors under Article 23(d).

Objective reasons to contract a discharge

134. EFAMA (large majority of members) disagreed with the proposal in option 2, considering it incompatible with the L1 text in the sense that the existence of a written contract does not by itself constitute an objective reason. EFAMA preferred option 1 for reasons of clarity. ABI 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.

135. AIMA, EVCA, ETDF, EBF, AGC, AFME PBC supported option 2 for reasons of clarity and objectivity (AIMA), any other approach would favour the largest banks (EVCA), it was the most pragmatic option and the notion of 'best interests of the AIF and its investors' was too broad (ETDF, AGC), option 1 did not provide legal certainty on such notions as 'no other option' and 'agreed...it is in the best interest' (EBF), option 2 gave the necessary flexibility (AFME PBC).

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?

136. A study commissioned by AIMA suggested that a 'strict liability' approach for acts or omissions of all sub-custodians would increase costs by 4-5 times.

137. EVCA 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.

138. ETDF, AGC, EACB expected a significant increase in costs for depositaries as well as an increase in systemic risk.

139. AIC, ABI noted that assuming AuM of AIFM of €2 trillion (as set out in the original Directive proposal), even a one basis point increase would lead to additional costs of €200 million.

140. AFME PBC 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. AFME PBC 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.

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

141.EFAMA 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. ETDF, EBF agreed but proposed the following non-exhaustive typology (also EACB):

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).

142. AIMA 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.

143. EVCA gave a specific example involving a chain of transfers over a number of years and the existence of a forged transfer at a point in the chain, which in their view should be considered an external event.

144. AGC set out a detailed typology explaining the current view of whether the event would constitute a loss vs the expected impact of Box 90.

145. ABI did not see the need for a typology if the definition in Box 90 was retained.

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?

146. EFAMA recognised that the application of the criteria in Box 91 to situations where the local legislation does not recognise the effects of segregation will in some cases (but not automatically) lead to the event being considered 'external'.

147. AIMA strongly supported the proposal and added that matters relating to local legislation (as well as decisions of courts, regulators and other governmental entities) were inherently external. EVCA also saw no difficulty and stressed that the depositary cannot alter local laws.

148. ETDF, EBF, AGC, AFME PBC, EACB, ABI saw no particular difficulties provided that 'effects of segregation' was defined clearly (ETDF, EBF) – in essence ETDF, EBF considered the due diligence in relation to segregation as being an obligation of means and not of result. AGC recommended that the reference to local legislation not recognising 'the effects of segregation' be extended to the decisions of 'courts and regulatory bodies'. ABI 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.

Are there other events which should specifically be defined/presumed as 'external'?

149. EFAMA 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.

150. EBF 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. EBF also saw merit in extending Box 65 (Objective reasons for delegation) to depositaries.

151.AIMA, EACB identified the following non-exhaustive list:

- Acts or omissions of an unaffiliated sub-custodian (only AIMA, also ABI provided comments on ‘financial instruments’ and ‘loss’ taken into account)
- 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.

152. ABI 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.

153. ETDF, AGC also 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.

154. AGC 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 (AGC’s view was that in the latter case, the event should not be considered ‘internal’).

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?

155. AIMA, ETDF 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 (ETDF, EBF).

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?

156. AIMA 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).

157. EVCA were keen to avoid an approach that drove business into banks with huge proprietary networks.

158. ETDF 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 (also AGC), 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.

159. EBF 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. This might be instrumentalised by a provision in the written contract between the depositary and the 3rd party (as referred to in condition b) in the L1 Directive extract) authorising the depositary to act as an intermediary on behalf of the AIF , or AIFM, without being party to the claim itself.

160. AFME PBC 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.

161. AGC 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, AGC 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.

162. EACB doubted the feasibility of transferring the liability in practice on the basis that sub-custodians were unlikely to accept.

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?

163. AIMA 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).

164. EVCA 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.

165. ETDF, EBF favoured limiting the extent to which non-bank depositaries could acts as custodians for financial instruments.

166. AGC felt the framework was workable for PE and RE funds, provided option 2 was chosen in Box 78 and option 1 in Box 81.

167. EACB stressed the need to ensure a level playing field in the EU and for third countries between all depositaries.

168. ABI considered the mechanism to be legally complex and uncertain and questioned whether depositaries would be willing to enter into such arrangements with their clients on a commercial basis.

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?

169. ETDF sought further tailoring of the distinction between custody and other assets and highlighted its desire to see consistency between the UCITS and AIFMD frameworks.

170. EBF 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.

171. For AGC, 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.

172. EACB felt the more diversified nature of AIFs (compared to UCITS) had to be taken into account but not to the detriment of harmonisation.

Possible Implementing Measures on Methods for Calculating the Leverage of an AIF and the Methods for Calculating the Exposure of an AIF

General provisions on calculating the exposure of an AIF

173. EFAMA 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. For the European trade association it should be possible to use the VaR.

174. EVCA commented that the methodologies proposed by ESMA were neither necessary nor appropriate for private equity and venture capital funds. The trade association believed that the second sentence of paragraph 3 of Box 93 could be deleted. EVCA made also some drafting suggestions for paragraph 1 which should read as follow:

- ESMA has been requested by the Commission to provide advice on the appropriate method or methods for the calculation of leverage for the purposes of Directive 2011/61/EU. ESMA considers that *there are certain types of long-only fund where the most appropriate way to report leverage is by disclosure of the extent of their borrowing, guarantees or commitments which are not covered by investor commitments alongside the fund's NAV.* In all *other* cases the overall leverage of an AIF can be expressed as a ratio between the exposure of an AIF and its net asset value; however the method of calculating exposure needs to be further de-fined. *An AIF that invests only in long equity or debt positions, does not hold financial derivative instruments (FDIs) (other than FDIs used to hedge risks relating to its investments denominated in currencies other than the AIF's reporting currency) and does not engage in any methods of increasing the exposure of AIFs managed by it other than cash borrowings and/or guarantees shall not be considered to be 'leveraged' for the purposes of the AIFMD or, to the extent that it does utilise cash borrowings or enter into guarantees, it should report the extent of such borrowings or guarantees as its leverage (except to the extent that the obligations are fully covered by investor's capital commitments).*

175. For AIMA, the text in Box 93 should be much clearer about what is proposed to be calculated and what should be reported to competent authorities.

176. For VAI, the commitment approach seemed to be the most suited method, because of the AIFMD covers a wide range of AIFs. However, since the commitment method can only be applied in the case of non-complex derivatives, VAI recommended the use the Var.

177. For Assogestioni, gross method was not appropriate and would not be useful information to be disclosed to investors. The Italian trade associate was also of the view that there should be only one method, the advanced method.

178. BVI disagreed with the requirement to calculate the leverage according the gross and the commitment methods. Accordingly, disclosure to investors of leverage should only be done based on the method chosen by the AIFM. Should this proposition not taken into account, BVI proposed that only leverage figure based on the commitment method should be disclosed to investors and reporting to competent authorities could be complement by a leverage figure based on the gross method.

Exposure related definitions

179. For EFAMA, the definition of netting and hedging arrangements were highly restrictive and did not reflect the market practice. AIMA disagreed as well with the definition of netting and hedging arrangements. IMA was also of the view that the definitions of netting and hedging arrangement were highly too restrictive.

Gross method of calculating the exposure of the AIF

180. Some EFAMA members 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. For futures, it is common to use the margin to equity ratio. EFAMA also pointed out that some of EFAMA's members (IMA, Assogestioni) were of the view that borrowing should be excluded from the gross method when that borrowing is reinvested – as the re-investment is already captured. Finally, EFAMA felt appropriate that paragraph 25 of the explanatory text clarified that leverage in any holding company structure was also to be excluded.

181. AIMA strongly disagreed with the use of gross method as proposed by ESMA. According to AIMA, the most appropriate method should be an adjusted commitment/gross method. The adjustments should be mainly in the form of treating derivatives exposures in the line with the treatment of derivatives under Basel III regime which as recently proposed in the CRD IV. However, AIMA agreed the gross method could be used for reporting obligations to competent authorities with

some modifications. Derivatives with positions limited downside should be represented by their maximum loss.

182. For AFG, gross method was misleading. This measure for AFG is too simple and is not relevant to ESMA's objectives in particular because it includes the leverage attached to derivatives and exchange rates. The French trade association believed that the exposure at the level of underlying funds in the case of fund of funds should not be taken into account in the calculation of the exposure of the fund of funds.

Commitment method of calculating the exposure of an AIF

183. For EFAMA, 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. EFAMA was also of the view that interest swaps which are widely used in real estate funds should be included in the paragraph 3 as well.

184. AIMA disagreed with 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. However, while being too strict, AIMA welcomed the possible use of netting arrangements which permits duration matching rules for interest rate strategies.

185. For AFG' the commitment method was more preferable.

Advanced method of calculating the exposure of an AIF

186. EFAMA members disagreed with the requirement to calculate the advanced method besides the commitment method, instead of as an alternative to it.

187. For IMA it was not clear how the advanced method would reduce the complexity since leverage calculation according both gross and commitment methods must be performed.

Method of increasing the exposure of an AIF

188. It was suggested by EFAMA to align the definition of futures contract and forward agreements with the definition of the CESR's guidelines on Risk Measurement and the Calculation of the Global Exposure and Counterparty Risk for UCITS.

189. For AIMA, the treatment of repo was not clear enough.

Exposures involving third party legal structures

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?

190. EVCA agreed with the proposed list.

191.AIMA was of the view that it was not appropriate to prescribe a list of specific method because of the wide spectrum of derivatives that can embed leverage.

192. For IMA and ABI, credit default swaps and spread betting should be added to the list. The trade association was also of the view that total return swaps an interest rate swaps should not be listed separately when they are Contract for Difference. Assogestioni also suggested the inclusion of credit default swaps.

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?

193. EFAMA recommended that VaR should be a permitted advanced monitoring method where appropriate for the particular AIF.

194. AIMA welcomed the possible use of an advanced method as an additional leverage measure but felt that ESMA should reconsider the use of the VaR by hedge funds.

195. EVCA was of the view 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.

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?

196. The majority of respondents (EFAMA, AIMA, IMA, Assogestioni, VAI, INREV, EVCA and FVCA) 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 (AIMA, IMA and Assogestioni) also felt that the definition 'cash and cash equivalent' should be addressed and VAI believed that all the currencies held by the fund should be excluded.

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

197. Respondents to the consultation expressed mixed views on this topic. For EVCA and BVI, none of the three options were satisfactory while AIMA, VAI and AFG supported option 3. EVCA proposed the following drafting: 'AIFMs shall include in the calculation of leverage any increase in the exposure of an AIF created by financial and/or legal structures involving non-listed companies or issuers controlled by the AIFM within the meaning of Article 26 if an only to the extent that such structures create recourse to the AIF for obligations of such non-listed companies or issuers and only to the extent that any such obligations are not covered by undrawn capital commitments from investors.'

198. IMA did not favour option 2 and was of the view that option 3 may create uncertainty for many AIF. ABI also had mixed on this issue.

199. A majority of EFAMA's members expressed a preference for option 1.

200. According to FVCA, option 2 seemed to be the one to come closest to private equity and venture capital industry.

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?

201. For AIMA, leverage in a 3rd party entity should only be included in respect of a particular AIF if there is legal recourse such that the AIF's liability exceeds its investment value. IMA made the same comment.

202. For INREV, in non-listed real estate funds, financial and/or legal structures involving other entities controlled by the relevant AIF are common; however, they are not set up specifically to directly or indirectly create leverage at the level of the AIF. INREV believed that, even though it did not appear to be required under the advice given to ESMA, INREV agreed that the leverage reported by the AIF 'should represent the extent to which the AIF may be impacted by market risks attributable to its positions,' as stated in paragraph 3 of Box 93. Therefore, 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 INREV, 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 SPV 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.

203. EVCA disagreed with this suggestion. Leverage at such level is only included in the definition of leverage of the AIF in the Directive if and to the extent it increases the liability of the AIF.

Possible implementing measures on reporting obligations to competent authorities.

204. According to AIMA, ESMA should take into the account the need the need to minimise the administrative burden on competent authorities arising out of the transparency requirements of the Directive. Therefore, AIMA was 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, AIMA proposed that a benchmark for possible materiality be set at 3 billion of euros. According to AIMA, closed-ended funds that have low levels of turnover and market conditions are stable it may be appropriate for them to report for them to report an a semi-annual basis where they assets under management in excess of 3 billion of euros or an annual basis where they have assets under management below this threshold.

205. AIMA proposed the following table for reporting obligations to competent authorities:

Reporting requirement	**Frequency Options**	
	AIFM, with AUM </= €3bn	**AIFM, with AUM > €3bn**
1) Report a set of core information (Article 3 (3) (d) and 24 (1) for each AIF	Annual	Quarterly
2) Report information required under Article 24 (2) (a) to (d) for each AIF	Annual	Quarterly
3) Additional information required by AIFM managing one or more AIF employing leverage on a substantial basis (Article 24 (4))	Frequency should be in line with that set out in 2) above	

206. AIMA made also the point 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.

207. For INREV, information required under paragraphs 1(a) and 1(b) was not appropriate for non-listed real estate funds that do not generally invest in financial instruments. Furthermore, INREV expressed some concerns 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.

208. For EFAMA, the reporting requirements should endure a proper differentiation between the types of AIF having regard to the corresponding probability of systemic risk. In EFAMA's views EFAMA, such differentiation could be performed according to the predominant strategy which shall be specified for each AIF as the first item in the reporting template. On the basis of the categories provided by ESMA in page 432 of the consultation paper, the reporting duties should be attached first and foremost to AIFs following hedge fund strategies (column 1) and fund of hedge funds (column3) and the remaining types of AIFs should be granted some relief in their reporting obligations.

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

209. The vast majority of respondents (AIC, AIMA, EVCA, FVCA, EFAMA, AFG, IFIA, Assogestioni, BVI, ABI and IMA) disagreed with the proposed frequency of disclosure. For EFAMA, reporting requirement should be on an annual basis while AIMA proposed an approach based on the size of the AIFM (see table above). According to INREV there should be more flexibility and pointed out that for closed-end funds, quarterly reporting would not practicable.

210. For EVCA, the frequency of disclosure should be in line with the reporting to investors as required under the AIF rules or instruments of incorporation but at least annually. Also according to AIMA, requirements in paragraph 3 of Box 109 went beyond the requirements in the Directive and noted that the advice that ESMA is required to provide to the European Commission does not provide the remit to extend out the frequency of this disclosure. EVCA was also concern by paragraph 5 of Box 109 which could lead to significant disparity of treatment across the EU and market distortions and therefore proposed its deletion.

211.VGF disagreed with the proposed frequency and proposed that competent authorities should be given the possibility to reduce the frequency of reporting as well.

212. The ESRB believed that the reporting frequency could be adapted to the size and the nature of the investment.

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.

213. For AIC the reporting template was too detailed if quarterly requirement was to be retained by ESMA in the final technical advice. Also, this would be too onerous to complete and it was unclear how this information would be used. AIC was not able to provide with any cost estimations.

214. AIMA indicated the cost would vary across the different AIFs but did not provide with any estimates.

215. EFAMA and BVI anticipated high and initial and on-going costs without providing with any estimates. The trade association called for proportionality in the information required by ESMA due to the diversity of AIFs. For BVI, the template developed by IOSCO was not appropriate for many AIFs.

216. EVCA could support a template approach provided that it would be done a flexible basis. For EVCA the template proposed by ESMA incorporates a lot of elements which are not relevant for private equity and venture capital funds.

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?

217. AIMA did not feel that the proposed advice in relation to the assessment of whether leverage is employed on a substantial basis provided sufficient clarity.

218. For EFAMA, IMA and ABI the ESMA's approach was too subjective and would be interpreted differently by national competent authorities. ESMA should be more specific with more objective criteria. For BVI, the proposed approach would not practicable.

219. EVCA welcomed the proposed approach to leave flexibility to the AIFM to determine what degree of leverage should be considered 'substantial'. However, EVCA 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. According to AIC, the technical advice should set a minimum level where leverage would be deemed to be substantial and proposed a level of 100% (leverage of 2).

220. INREV agreed with ESMA's suggestion to use a self-assessment approach and has no further comments at this stage.