esma European Securities and Markets Authority

Consultation paper

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

July 2011 | ESMA/2011/209

Date: 13 July 2011
ESMA/2011/209

Responding to this paper

ESMA invites comments on all matters in this paper and in particular on the specific questions summarised in Annex 1. Comments are most helpful if they:

- indicate the specific question to which the comment relates;
- respond to the question stated;
- contain a clear rationale; and
- describe any alternatives ESMA should consider.

Comments should reach us by **13 September 2011**.

All contributions should be submitted online at www.esma.europa.eu under the heading 'Consultations'. Respondents should identify themselves and indicate the industry sector in which they operate or in which they are interested and the extent to which that sector is already subject to regulation at a national level. Respondents are also invited to consider the costs or benefits attached to the various options and quantify these costs to the extent possible.

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publically disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESMA's Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.esma.europa.eu under the heading 'Disclaimer'.

Who should read this paper

This paper will be of interest to managers, depositaries and prime brokers of alternative investment funds, investors in those funds, as well as associations or other bodies representing such entities.

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Acronyms used

AIF	Alternative Investment Fund
AIFM	Alternative Investment Fund Manager
AIFMD	Alternative Investment Fund Managers Directive (2011/61/EU)
AuM	Assets under management
CCP	Central counterparty
CEBS	Committee of European Banking Supervisors
CESR	Committee of European Securities Regulators
CFD	Contract for difference
CIU	Collective investment undertaking
ESFS	European System of Financial Supervision
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
GAAP	Generally Accepted Accounting Principles
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
IOSCO	International Organization of Securities Commissions
MiFID	Markets in Financial Instruments Directive (2004/39/EC)
NAV	Net asset value
OTC	Over-the-Counter
UCITS	Undertaking for Collective Investment in Transferable Securities
UCITS Directive	Directive 2009/65/EC
VaR	Value at Risk

I. Executive Summary

Reasons for publication

On 2 December 2010 the European Commission sent a request for assistance to CESR (now ESMA) on the content of the implementing measures for the Alternative Investment Fund Managers Directive (AIFMD)[1]. In this paper, ESMA is seeking feedback from external stakeholders on the draft advice to the European Commission on possible implementing measures[2] for the AIFMD.

Contents

This consultation paper sets out ESMA's proposals for possible implementing measures regarding the issues identified in the European Commission's request. The formal proposals for advice are contained in the boxes in Sections III to VIII of the paper, while further commentary and explanation is provided in the explanatory text.

General provisions, authorisation and operating conditions

This section includes draft advice on the implementing measures foreseen under Article 3 of the Directive, which cover the following issues:

- the identification of the portfolios of alternative investment funds (AIFs) under management by a particular alternative investment fund manager (AIFM) and calculation of the value of assets under management (Article 3(2));
- influence of leverage on the assets under management (Article 3(2));
- the determination of the value of the assets under management by an AIF for a given calendar year (Article 3(2));
- the treatment of potential cases of cross-holding among the AIFs managed by an AIFM (Article 3(2));
- the treatment of AIFMs whose total assets under management occasionally exceed and/or fall below the relevant threshold (Article 3(2));
- the content of the obligation to register with national competent authorities and suitable mechanisms for gathering information set out in Article 3(3);
- the registration requirements for entities falling below the thresholds set out in Article 3(3); and
- the procedures for small managers to 'opt-in' to the AIFMD set out in Article 3(4).

As regards general operating conditions, the advice covers the following elements:

[1] http://ec.europa.eu/internal_market/investment/docs/alternative_investments/level2/mandate_en.pdf
[2] This paper uses the term 'implementing measures' as a generic term to refer to delegated acts and implementing acts.

- initial capital and own funds;
- conflicts of interest;
- risk management;
- liquidity management;
- general principles;
- investment in securitisation positions;
- valuation;
- delegation of AIFM functions; and
- organisational requirements.

Depositaries

This section sets out ESMA's draft advice on the contract evidencing appointment of the depositary, depositary functions, segregation obligations, loss of financial instruments, external events beyond reasonable control and objective reasons to contract a discharge.

Transparency and leverage

The advice under this heading covers the definition of leverage and appropriate methods for its calculation, the content and format of the annual report to be prepared by the AIFM, disclosure to investors, the use of information by competent authorities and limits to leverage.

Next steps

In light of the feedback received from stakeholders, ESMA will finalise its proposals with a view to submitting its advice to the European Commission by the deadline of 16 November 2011.

II. Introduction and background

1. The European Commission's proposal for a Directive on Alternative Investment Fund Managers was published in April 2009[3]. Following intensive negotiations among the co-legislators over the period that followed, a political compromise was reached on the draft Directive in October 2010. The following December, the Commission sent a request to CESR (now ESMA) for technical advice on the detailed implementing measures that should form part of the AIFMD framework. The Commission's request is split into four parts:

    - Part I: General provisions, authorisation and operating conditions
    - Part II: Depositary
    - Part III: Transparency requirements and leverage
    - Part IV: Supervision

2. This consultation paper (CP) sets out ESMA's draft advice on most of the elements covered under Parts I to III of the Commission's request. A summary of the issues covered under each part is set out below.

3. Immediately upon receipt of the request for assistance, CESR published a call for evidence (Ref. CESR/10-1459)[4] inviting stakeholders to provide input on the main elements of the request. A total of 56 responses were received by the deadline of 14 January (the non-confidential responses are available on the ESMA website[5]).

4. The final text of the AIFMD, which will take effect in July 2013, was published in the Official Journal on 1 July.[6] All references to articles in this consultation paper relate to that version.

5. Certain of the implementing measures foreseen under Part IV of the request are less urgent as they relate to the introduction of a passport for third country entities, which would not be operational until at least two years following the transposition deadline for the AIFMD. However, the co-operation arrangements referred to in the implementing measures under Articles 34(1), 36(1) and 42(1)(b) have to be in place as from the first day the national laws transposing the AIFMD take effect in 2013. ESMA has been working on developing draft proposals for these implementing measures, which will be contained in a separate consultation to be published later in the summer, with a view to submitting the advice to the Commission by 16 November.

Part I: General provisions, authorisation and operating conditions

Article 3 exemptions

6. This section of the draft advice includes the implementing measures foreseen under Article 3 of the Directive, in respect of which sufficiently rapid progress was made so as to allow the publication of a

[3] http://ec.europa.eu/internal_market/investment/docs/alternative_investments/fund_managers_proposal_en.pdf
[4] http://www.esma.europa.eu/popup2.php?id=7318
[5] http://www.esma.europa.eu/index.php?page=responses&id=176
[6] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:0073:EN:PDF

discussion paper on policy orientations. This discussion paper (ESMA/2011 /121)[7] was published on 15 April with a deadline for contributions of 16 May. The feedback in the 17 responses received[8] has been taken into account in the refinement of the proposals in the relevant part of the CP.

General operating conditions

7. The overall approach taken to the draft advice on general operating conditions has been to align the requirements as much as possible with the existing provisions in the UCITS Directive and MiFID, while recognising that the UCITS Directive covers retail-oriented funds. Since MiFID in many cases makes more of a distinction between retail and professional clients, the relevant provisions have been an important source of inspiration in light of the fact that AIFs are generally sold to professional investors. A summary of the issues covered by the advice on this part of the Commission's request is set out below.

Initial capital and own funds

8. Under this part of the advice, ESMA is requested to provide the Commission with a description of the types of risk arising from professional negligence and to advise on methods for calculating the respective amounts of additional own funds or the coverage of the professional indemnity insurance. On the calculation of additional own funds, the advice provides two options: the first is based on the variable assets under management (AuM), while the second also takes into account the variable income. The second option is therefore partially based on the approach taken in Directive 2006/48/EC i.e. the Basic Indicator Approach, and includes the assumption that liability risks may not only rise with the value of the AIF's portfolios but also with the income of the AIFM.

General principles and organisational requirements

9. ESMA is requested to advise the Commission on criteria to be used by the relevant competent authorities to assess whether AIFMs comply with the general principles under Article 12(1) of the AIFMD (such as the duty to act with due skill, care and diligence and the need to have appropriate resources and procedures), as well as on the content of rules that are proportionate and necessary for the specification of the general obligations placed on an AIFM by Article 18(1) (including the need for sound administrative and accounting procedures and adequate internal control mechanisms). The advice in this area seeks to achieve an appropriate level of consistency with the UCITS and MiFID regimes while taking into account the diversity of AIFs and different types of assets in which they are invested. However, as UCITS provisions are tailored for open-ended investment funds that generally invest in financial instruments, this advice provides adjustments or exemptions for those AIFs that are not open-ended and invest in other assets than financial instruments. Regarding the organisational requirements, ESMA's proposals are based on the view that these should be applied proportionately in view of the nature, scale and complexity of the AIFM's business and the nature and range of its activities.

Conflicts of interest

10. ESMA is requested to provide the Commission with a description of the types of conflicts of interest between the various actors as referred to in Article 14(1) of the AIFMD. Furthermore, ESMA is requested to advise the Commission on reasonable steps an AIFM should be expected to take. These steps

[7] http://www.esma.europa.eu/popup2.php?id=7547
[8] The non-confidential responses are available here: http://www.esma.europa.eu/index.php?page=responses&id=181

must be defined in terms of structures and organisational and administrative procedures in order to identify, prevent, manage, monitor and disclose conflicts of interest. With regard to the description of the types of conflicts of interest, ESMA took into account that the UCITS Directive and and MiFID Level 2 measures already set out situations in which conflicts of interest may arise. The advice is based on these Level 2 provisions and describes situations in which conflicts of interest may arise. ESMA has also considered it useful to give some examples for specific conflicts of interest, some of which are taken from the November 2010 IOSCO report, 'Private Equity Conflicts of Interest'[9].

Risk management

11. The advice on risk management covers three main topics:

    i. the establishment, organisation, role and responsibilities of a permanent risk management function including requirements in respect of its reporting to senior management and its functional and hierarchical separation from other operating units including portfolio management;

    ii. the establishment of a risk management policy and the process and frequency for the assessment, monitoring and review of this policy; and

    iii. the processes and techniques for the measurement and management of risk including the use of qualitative and quantitative risk limits for certain types of risks.

    The existing provisions on risk management in the UCITS Directive and MiFID were taken as a starting point for the work and have in many cases been included in the draft advice with limited tailoring.

Liquidity management

12. In line with the request from the Commission, the following issues are addressed in the draft advice on liquidity management:

    i. the systems and procedures AIFMs should implement to ensure the liquidity profiles of the AIFs under their management comply with their underlying obligations;

    ii. the content and frequency of stress tests to be performed by AIFMs; and

    iii. the circumstances under which the investment strategy, liquidity profile and redemption policy of each AIF managed by an AIFM can be considered to be consistent.

    The existing requirements under the UCITS Directive were taken as the starting point for the development of the draft advice. Regard was also had to industry guidance and good practice standards.

Investment in securitisation positions

13. ESMA is requested to advise the Commission on the requirements for investment in securitisation positions by AIFMs on behalf of one or more AIFs (Article 17 AIFMD) or by UCITS (Article 63 AIFMD).

[9] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD341.pdf

The objective of these provisions is to ensure cross-sectoral consistency and remove misalignment between the interest of firms that repackage loans into tradable securities and originators within the meaning of the Banking Consolidation Directive (Directive 2006/48/EC). ESMA has also taken into account the relevant provisions of the Capital Requirements Directive (Article 122a), Solvency II Directive (Article 135) and the advice given by CEBS and CEIOPS respectively in this regard.

Valuation

14. ESMA is requested to advise the Commission on criteria for the proper valuation of assets and the calculation of the net asset value, the type of specific professional guarantees an external valuer should be required to provide and the frequency of valuation carried out by open-ended funds.

15. On the first point, ESMA recognises the different existing valuation standards, taking into account different rules in different jurisdictions and the diversity of assets invested in by AIFs. ESMA has sought to identify general principles that should guide the AIFM in developing and implementing policies and procedures for a proper and independent valuation of the assets of the AIF. Due to their general character these requirements can be adapted to the specific characteristics of diverse types of asset in which an AIF may invest.

16. In respect of the calculation of the net asset value (NAV), ESMA has taken into account that the rules applicable to the calculation of the NAV are subject to the national law of the country where the AIF has its registered office or those laid down in the AIF's rules or instruments of incorporation. The advice also sets out some general principles on the calculation of the NAV. As a general rule it is considered that the valuation of assets that are financial instruments must take place every time the net asset value is calculated. However, the valuation of assets that are not financial instruments must take place at least once a year.

Delegation of AIFM functions

17. The Commission's request invites ESMA to advise on the content of rules that are necessary and proportionate to ensure that an AIFM fulfils the conditions for delegation of functions under Article 20(1) and (2). With regard to the criteria for objective reasons justifying a delegation, the advice sets out two options for consultation. The first takes a flexible approach according to which a delegation can be justified where the AIFM can demonstrate that the delegation is done for the purpose of a more efficient conduct of the AIFM's management of the AIF. This approach is more closely aligned with the requirement in the UCITS Directive that refers to the delegation purpose 'of a more efficient conduct of the companies' business'. The second option sets out an indicative, non-exhaustive list of criteria to be used when making the assessment.

18. Regarding the assessment of whether an entity to which functions are delegated is of sufficiently good repute, ESMA takes the view that this is satisfied where the delegate is established in the EU and is authorised or registered for the delegated tasks and the fulfilment of the criterion has been reviewed by the competent supervisory authority within the authorisation procedure. In all other cases the AIFM has to evaluate whether the delegate complies with the criteria on 'sufficient resources, sufficiently good repute and sufficient experience'. The advice sets out some guidance for this evaluation.

19. Finally under this heading, ESMA is of the view that there are two situations under which an AIFM should be considered as a letter-box entity. First, when the AIFM is no longer able to supervise the

delegated tasks effectively and to manage the risks associated with the delegation. The second case arises when the AIFM no longer has the power to take decisions in key areas that fall under the responsibility of the senior management or to perform senior management functions.

Part II: Depositary

20. The draft advice on depositaries covers the following elements:

    i. Appointment of the depositary

    ii. The depositary's duties

    iii. The depositary's liability regime

Appointment of a depositary

21. In line with the request from the Commission, the draft advice on this point sets out ESMA's proposals on the content of the contract evidencing the appointment of the depositary, which must at least regulate the flow of information necessary to enable the depositary to perform its functions. The particulars required in the contract to be signed between the depositary and the management company in the UCITS Directive were taken as a starting point with a view to ensuring consistency across the industry.

22. Due to the very diverse nature of the entities subject to the Directive, it has not been considered appropriate to develop a model agreement. This is also in line with the approach taken in CESR's advice on the UCITS IV Directive in relation to depositaries.

Duties of the depositary

23. The depositary has two primary functions: to safekeep the AIF's assets and to oversee its compliance with the AIF's rules and instruments of incorporation and with applicable law and regulation. The Directive further assigns the depositary with a requirement to ensure the AIF's cash flows are properly monitored.

Safekeeping

24. The duty to safekeep consists either of custody or of record keeping, depending on the type of asset. In line with the Commission's request, the draft advice addresses the types of financial instrument which should be included in the scope of the depositary's custody functions and the conditions upon which the depositary can fulfil its obligation to safekeep the assets. The 'other assets' subject to the record-keeping obligation are then defined as all assets not covered by custody. The advice sets out a number of different options in this area, each of which has potentially different consequences for the scope of the custody duty.

Oversight function

25. The AIFMD contains the same provisions regarding the depositary's oversight functions as those set out in the UCITS Directive. However, in light of the differences in interpretation of the five oversight duties of a depositary across Member States, the draft advice aims to clarify each task.

Cash monitoring

26. The draft advice considers the depositary's cash monitoring function as a general requirement to have a full overview of all cash movements of the AIF which should be read alongside its oversight duties. The advice acknowledges that an AIF may have cash accounts at various entities outside the depositary; as such, the aim is to have a strong requirement on the AIFM to ensure the depositary has access to all information related to each cash account opened at a third party.

27. The draft advice sets out two options regarding the tasks which would be expected of a depositary when implementing its cash monitoring obligations. One option would be to consider the depositary 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. The second option identified would require the depositary to ensure there are procedures in place to appropriately monitor the AIF's cash flows and that they are effectively implemented and periodically reviewed. In particular, the depositary would be required to look into the reconciliation procedure and monitor that remedial action is taken without undue delay whenever a discrepancy is identified.

28. Under its cash monitoring function, the depositary is also required to ensure that payments made by investors upon subscription have been received by the AIF. ESMA has put forward advice with a view to clarifying that the depositary is not expected to interfere with the distribution channels of the AIF but simply to verify the information at the level of the AIF's register.

Due diligence duties

29. Article 21(11) of the Directive provides significant detail as to the conditions to be met for the depositary to be able to delegate any of its safekeeping functions. ESMA has been asked to provide further guidance in relation to the specific tasks the depositary would be expected to carry out in order to comply with its due diligence duties and, if possible, to provide a template of evaluation, selection, review and monitoring criteria to be considered. The advice focuses on what the depositary is expected to do when delegating custody tasks given the potentially significant implications for the AIF and its investors.

Segregation

30. The third party to which the depositary wishes to delegate custody tasks must segregate the assets belonging to the depositary's clients from its own assets and from assets of the depositary in such a way that they can at all times be clearly identified as belonging to clients of a particular depositary. The Commission has asked ESMA to clarify what the specific requirements should be to make sure the sub-custodian effectively meets that obligation. The draft advice is based on Article 16 of the MiFID implementing Directive (2006/73/EC), adapted to reflect that sub-custodians may, as the AIFMD acknowledges, use 'omnibus accounts'.

Depositary liability

31. The depositary's liability regime is a central issue of the AIFMD. The advice aims to strike the appropriate balance between the Directive's objective of ensuring a high level of investor protection while refraining from placing the entire responsibility on depositaries. With this objective in mind, the proposed advice attempts to provide clear definitions of what would constitute: (i) the loss of a financial

instrument; (ii) an external event beyond the reasonable control of a depositary, the consequences of which would have been unavoidable despite reasonable efforts; and (iii) the objective reason which could enable a depositary to discharge its responsibility by transferring it to a sub-custodian.

Part III: Transparency requirements and leverage

32. The draft advice under this heading covers the implementing measures foreseen under Articles 4 and 22-25 of the AIFMD.

Leverage

33. Three aspects related to leverage are addressed in the draft advice:

- the methodologies to be adopted for calculation of leverage under Article 4 of the Directive;
- the methods by which AIFMs increase the exposure of AIFs under their management through the borrowing of cash or securities, through leverage embedded in derivative positions or by any other means; and
- the principles specifying the circumstances under which competent authorities will exercise the powers to impose leverage limits or other restrictions on AIFMs under Article 25 of the Directive.

34. The approach adopted for the calculation of global exposure in the guidelines produced by CESR on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (Ref. CESR/10-788[10]) were taken as the starting point for the work. However, the policy approach was developed so as to permit more than one methodology for the calculation of leverage, taking into account the much broader range of entities covered by the Directive.

35. The following approach is set out in the draft advice:

- the 'exposure of an AIF' is to be calculated and reported by an AIFM to competent authorities in accordance with two mandatory methods, referred to as 'gross' and 'commitment' methods;
- a third method for calculating the 'exposure of an AIF' (which would in all cases be in addition to the two mandatory methods mentioned above) can be adopted by an AIFM at its request, or at the request of its competent authorities, subject to the condition that neither of the two mandatory methods for calculation provide an accurate representation of the exposure of the relevant AIF, including due to the investment strategy or the nature of the assets in which the AIF invests;
- the overall leverage of an AIF can be expressed as a ratio between the exposure of an AIF and its net asset value.

36. The Commission's request seeks input on the circumstances under which competent authorities will exercise the powers to impose leverage limits or other restrictions on AIFMs in order to ensure the sta-

[10] http://www.esma.europa.eu/popup2.php?id=7000

bility and integrity of the financial system. In this regard, the following elements have been set out in the draft advice:

- the circumstances under which an assessment must be performed by competent authorities in determining when to exercise their powers;

- the factors that must be taken into account by competent authorities when exercising their powers including the strategies of AIFs, the market conditions in which the AIFs operate and the effectiveness of the measures that are taken; and

- the additional actions that competent authorities must take when exercising their powers.

Transparency

37. The advice in relation to transparency covers three broad elements:

- the annual reporting requirements that an AIFM must apply in respect of each AIF under its management which is marketed in the EU, including the content and format of a balance sheet/statement of assets and liabilities, the income and expenditure account and the report on activities of the AIF;

- the periodic and regular disclosures that AIFMs must make to investors including in respect of the arrangements for managing the liquidity of AIFs under their management (and the percentage of assets subject to special arrangements), the risk profile of AIFs and the systems employed by the AIFM to manage risk, and information about the leverage employed by AIFs; and

- the information that AIFMs must provide, make available or report to competent authorities including in respect of the principal markets and instruments in which AIFs under their management trade, the sources of leverage they use and their most important concentrations.

Part IV: Supervision

38. As noted above, the most urgent of the issues falling under this part of the Commission's request will be addressed in a separate consultation later in the summer. ESMA recognises the importance of this part of the advice and will bring forward its detailed proposals as soon as possible, with a view to ensuring a smooth transition to the new framework in 2013.

Cross-cutting issues

39. There are a number of issues of general relevance that should be taken into account when considering ESMA's draft advice.

40. The first relates to the fact that the provisions in the AIFMD were drafted with marketing of units or shares of AIFs to professional investors (under the MiFID definition) in mind. Recital 71 of the Directive specifically addresses this point, explaining that Member States (MS) may allow the marketing of all or certain types of AIF managed by AIFMs to retail investors in their territory but that in such cases MS should be able to impose stricter requirements on AIFs and AIFMs as a precondition for marketing to retail investors than is the case for AIFs marketed to professional investors in their territory. In addi-

tion, the cross-border passport foreseen under Article 32 of the Directive applies to sales to professional investors only. ESMA's advice should therefore be considered as a minimum set of requirements that would apply when AIFs are marketed to professional investors and is entirely without prejudice to the additional obligations that MS may consider it appropriate to impose when marketing to retail investors is permitted.

41. Another issue that is of relevance to the advice as a whole is the differentiation of the requirements according to the type of AIFM. The Commission's request explicitly envisages such differentiation and ESMA has sought to reflect this in its advice. This is an area in which it will be particularly helpful to receive feedback from external stakeholders, with a view to ensuring that the requirements are tailored as much as possible to the wide range of entities covered by the AIFMD. Stakeholders should also note the relevance of the regulatory technical standards (RTS) foreseen under Article 4(4) of the Directive in this context. As indicated in the Commission's request, these RTS should be seen as an integral part of the overall AIFMD framework. ESMA has already started preparatory work with a view to developing these RTS but this paper does not contain formal proposals on their content. ESMA will continue to work on these RTS and publish a proposal in time to allow for their adoption in parallel with the package of implementing measures.

42. On a related point, the AIFMD makes provision for a significant number of technical standards (both regulatory and implementing) and guidelines. The technical standards which ESMA is obliged to develop relate mainly to the third country passport; as such, work on these will be carried out at a later stage. For the technical standards that are discretionary (i.e. ESMA 'may' develop them), ESMA will consider further which should be considered as a priority in view of the expected adoption of the package of implementing measures by the Commission by mid-2012.

43. Finally, respondents are invited to note the detailed cost-benefit analysis (CBA) contained in Annex III of this paper. In line with the Commission's request, ESMA has assessed the potential costs and benefits of its proposals and of, where appropriate, alternative options to the one proposed for consultation. This is designed to help ESMA in formulating its policy proposals and to feed into the Commission's own impact assessment work. In this context, it would be useful to ESMA to receive detailed feedback on whether any of the proposed measures would be inappropriate or unduly costly compared to alternative measures which would also ensure the achievement of the objectives of the Directive. Respondents are invited to take this into account when replying to the questions in the document. In particular, information about costs triggered by the proposed implementing measures which go beyond the costs that would already be triggered by the Level 1 Directive would be helpful. Cost assessments or calculations should only take into account the additional costs arising from the specifics of the proposal, and not include costs that firms already face now due to national legislation or costs that arise from the Level 1 Directive.

III. Article 3 exemptions

III.I. Identification of the portfolio of AIF under management by a particular AIFM and calculation of the value of assets under management

Extract from the Commission's request

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

The advice should identify options on how to determine the value of the assets under management by an AIF for a given calendar year. It should indicate the method or methods CESR regards as preferable.

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

CESR is requested to advise the Commission on how best to deal with potential cases of cross-holdings among the AIF managed by an AIFM, e.g. funds of AIF with investments in AIF managed by the same AIFM.

CESR is requested to advise the Commission on how to treat AIFM whose total assets under management occasionally exceed and/or fall below the relevant threshold in a given calendar year. As part of this work, CESR is requested to specify circumstances under which total assets under management should be considered as having occasionally exceeded and/or fallen below the relevant threshold in a given calendar year.

CESR is requested to advise the Commission on the obligation of AIFM to notify competent authorities in the event they no longer comply with the exemptions granted in Article 3(2).

Introduction

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

2. It is the responsibility of the AIFM to establish whether it must obtain authorisation under the AIFMD or whether it can benefit from the exemption under Article 3(2). To do this the AIFM must identify the AIFs under its management for which it would be appointed AIFM under the Directive. The AIFM must then calculate the assets under management of these AIFs to establish if it can benefit from the exemptions under Article 3(2).

3. In accordance with Article 3(2)(a) the calculation of the value of assets under management means assets under management in total, including any assets acquired through leverage. The exemption set out in Article 3(2)(b) only applies to non-leveraged AIFs.

4. For most open-ended AIFs where the net asset value is calculated it would seem appropriate that the current net asset value could be used to calculate the assets under management, including assets that have been acquired through leverage.

5. For other types of AIF the net asset value may not adequately represent the size of the fund in relation to the specific moment of its life (for instance, closed-ended funds at the beginning of their life may have a very large capital commitment, but only small amounts actually invested). Moreover, different types of AIF will apply different methodologies to the valuation of their underlying assets for the purposes of calculating gross and net asset value. This may include value by reference to market value, mark to model or some other means of assessing fair value. Some AIFs may value assets by reference to cost (for example venture capital funds), while others may require valuation to be carried out by prescribed experts (for example real estate funds).

6. ESMA has considered what factors could be taken into account in assessing the value of portfolios of AIFs, including closed-ended AIFs where the value is calculated less frequently or those AIFs which do not produce a gross or net asset value. In the case of these AIFs it would be useful to consider industry practice taking into account, for example, the basis on which fees are calculated or whether these AIFs (or the assets which compose their portfolio) are subject to an annual audit.

7. ESMA considered whether there may be a need for differentiation between open-ended funds and closed-ended funds for the calculation of the value of assets under management. For the latter, the net asset value may not be relevant or calculated with sufficient frequency and perhaps other methods could be used, such as acquisition cost of assets held, or commitments less realisations at cost for private equity and venture capital AIFs.

8. The advice should identify options on how to determine the value of the assets under management by an AIF for a given calendar year. It should indicate the method or methods ESMA regards as preferable.

9. In assessing whether the AIFM can avail of the exemption on an ongoing basis, ESMA considered whether the assets under management should be calculated at one point in time i.e. the end of the calendar year. An alternative approach would involve taking an average of assets under management over the period, or calculating the total value of the assets under management on a more frequent basis, for example quarterly. This would help deal with situations where the threshold is exceeded temporarily and help AIFMs to monitor their assets under management on an ongoing basis. However, ESMA must also take into account those AIFs which do not produce regular net asset value calculations.

10. Respondents to the call for evidence felt that information included in the audited annual reports should be used, with the possibility to use a different figure for total assets under management when it has changed significantly from the last annual reports of the AIF under management.

11. It is considered that taking a single 'snap shot' of assets under management on a particular day in a calendar year would not be sufficient to properly assess the AIFM's position in relation to the threshold. ESMA is therefore proposing that the threshold should be calculated at least annually by each AIFM and the total value of the assets under management should be monitored on a quarterly basis taking the latest net asset value calculation for each AIF, if available, or an appropriate value of the AIF's portfolio.

12. ESMA is requested to advise the Commission on how best to deal with potential cases of cross-holding among the AIFs managed by an AIFM e.g. funds of AIFs with investment in AIFs managed by the AIFM. ESMA identified two options in relation to cross-holdings between AIFs under management:

    Option 1

    Include all assets under management of each AIF, including assets which represent cross-holdings in other AIFs managed by the same AIFM. This has the advantage of simplicity and clarity; in addition AIFMs must manage each AIF and related portfolio separately. A fund of funds or master/feeder structure involves separate investors, fees, investments and risk management at each level. Therefore, it could be argued that it is appropriate to ignore all cross-holdings in the calculation of the threshold.

    Option 2

    Alternatively, allow AIFMs to exclude investments by AIFs in other AIFs under management from the calculation of the total value of assets under management. This is because, on a look-through basis, there is only one set of underlying assets which should be included in assets under management. However, this raises issues in relation to leveraged exposure to other AIFs or exposure achieved through the use of financial derivative instruments, which should not be excluded from the calculation of the total value of assets under management.

13. As the majority of respondents to the initial consultation supported option 2 and taking into account the fact that on a look-through basis, there is only one set of underlying assets which should be included in total value of assets under management, ESMA is recommending that AIFMs have the option to exclude cross-holding between AIFs managed by the same AIFM provided assets acquired through leverage are included in the threshold calculation.

14. ESMA is requested to advise the Commission on how to treat AIFMs whose total assets under management occasionally exceed and/or fall below the relevant threshold in a given calendar year. As part of this work, ESMA is requested to specify circumstances under which total assets under management should be considered as having occasionally exceeded and/or fallen below the threshold in a given calendar year.

15. This issue is linked to the question from the Commission request set out above ('Determination of the value of the assets under management by an AIF for a given calendar year'). ESMA considers that it would not be practical if AIFMs were continually falling in and out of the scope of the AIFMD. It is nevertheless very possible that the value of each AIF's underlying assets could change constantly depending on the investment strategy, market exposure and level of leverage employed. There is a danger if AIFMs calculated the threshold only once a year that this could ignore periods where the assets under management, including assets acquired through leverage, significantly exceeded the threshold. AIFMs should monitor their total assets under management on a continuous basis to assess whether they can continue to avail of the exemption but it may not be practical to expect them to continuously calculate the total value of assets under management. In monitoring the total value of assets under management the AIFM should consider factors including subscription and redemption activity, committed capital drawdowns, changes in market value of assets and net asset value calculations of AIFs since the last threshold calculation. The total value of assets under management should be calculated and/or monitored with sufficient frequency to provide on-going information on the assets under management and should take account of small or temporary increases above the threshold.

16. Respondents to the call for evidence expressed mixed views on this issue. Some felt that the AIFMD should also apply to AIFMs which temporarily exceed the threshold but that there should be a possibility for these AIFMs to ask competent authorities to waive this obligation, provided there is a common approach across Member States. Other respondents suggested that only AIFMs which exceed the threshold over a given period of time (for example over 3 or 6 months) by more than a given percentage (for example 10%) should be required to comply in full with the Directive.

17. A number of industry responses to the consultation on policy orientations supported a single clear methodology for the calculation of the threshold for both open and closed-ended funds. They also suggested a consistent approach throughout the Directive for the definition and calculation of leverage.

18. A majority of respondents also considered that it is sufficient for AIFMs to calculate the threshold annually. A majority also considered that requiring a quarterly calculation of the threshold would be too onerous and costly and many real estate funds for example would need to resort to external valuers. Therefore it is proposed that the threshold should be calculated annually using net asset value of AIFs and that the AIFM would monitor (but not re-calculate) their asset under management on at least a quarterly basis to establish whether a more frequent calculation would be required. Given the diverse nature of the assets under management of AIFs it is proposed that the advice does not stipulate the values used to monitor assets under management. However if AIFMs consider that the threshold will be exceeded and this is not a temporary occurrence then an application for authorisation must be made under Article 7 of the Directive.

Box 1

Calculation of the total value of assets under management

1. In order to avail of the exemption set out in Article 3(2) the AIFM must carry out the following procedure:

   - Identify the AIF as defined in the AIFMD for which it is the AIFM where the legal form of the AIF permits internal management or the appointed external AIFM, in accordance with Article 5;

   - Calculate the value of the assets under management, including assets acquired through leverage, of each AIF to establish whether the assets under management of all AIFs exceed the threshold. UCITS for which the AIFM acts as the designated management company under the UCITS Directive are not included in the threshold calculation.

2. The total value of the assets under management should be calculated at least annually using the latest available net asset value calculation including assets acquired through leverage for each AIF. The latest available net asset value for each AIF must be produced within 12 months of the threshold calculation date. The AIFM must apply a consistent approach to the selection of the annual threshold calculation date and any change to the date chosen thereafter must be justified to the competent authority. In selecting the annual threshold calculation date the AIFM should take into account in particular, the net asset value calculation time and frequency of the AIFs under management.

3. Where an AIF invests in other AIFs managed by the same externally appointed AIFM this investment may be excluded from the calculation of the AIFM's assets under management subject to appropriate adjustments for leveraged exposure in accordance with the provisions of Box 2. Where one compartment within an internally or externally managed AIF invests in another compartment of that AIF this investment may be excluded from the calculation of the internal AIFMs assets under management subject to appropriate adjustments for leveraged exposure in accordance with the provisions of Box 2.

4. AIFMs should implement and apply procedures to monitor the value of total assets under management, including subscription and redemption activity or where applicable capital draw downs and distributions, on an on-going basis and should where necessary, taking in to account proximity to threshold and anticipated subscription and redemption activity, recalculate the value of total assets under management.

5. The AIFM should assess situations where the value of total assets exceeds the threshold and, if it considers that the situation is not likely to be of a temporary nature, seek authorisation under Article 7 of the AIFMD.

    (a) Where the total value of assets under management exceeds the threshold the AIFM should notify the competent authority without delay stating whether the situation is considered to be of a temporary nature. This notification should, where relevant, include supporting information to justify the AIFMs view regarding the temporary nature of the situation.

    (b) The situation should not be considered to be of a temporary nature if it is likely to continue for a period in excess of three months.

    (c) At the end of the three month period the AIFM must recalculate the threshold to demonstrate that the total value of assets under management is below the threshold or demonstrate to the competent authority that the situation which resulted in the assets under management exceeding the threshold has been resolved and an application for authorisation of the AIFM is not required.

6. Competent authorities should have the right to check that the AIFM is correctly calculating and monitoring the total assets under management, including occasions when assets under management temporarily exceed the threshold.

Explanatory Text

19. The AIFM should include the assets under management of each AIF for which it would be the appointed AIFM. While UCITS managed by the AIFM are excluded from the calculation of the total value of assets under management, AIFs for which the AIFM would not require to be authorised in accordance with the transitional provisions set out in Article 61 of the Directive, must be included in the calculation. These 'exempt' AIFs are only included in the calculation to establish whether the AIF has exceeded the threshold. They are not subject to any other registration or reporting obligations under the

AIFMD. AIFMs who only manage these exempt AIFs are not required to calculate the total value of assets under management and are not subject to the requirements of the AIFMD.

20. The total value of assets under management for each AIFM should be calculated at least annually using the latest available net asset value calculation for each AIF. While is it recognised that some of the net asset value calculations for underlying AIFs may be carried out a number of months before the threshold calculation date it is important that the threshold includes up to date information. Therefore these net asset value calculations must be carried out within 12 months of the calculation of the total value of assets under management.

21. ESMA is proposing to give AIFMs the option to exclude investments by AIFs in other AIFs under management from the calculation of the total value of assets under management. This is because, on a look-through basis, there is only one set of underlying assets which should be included in assets under management. However, this raises issues in relation to leveraged exposure to other AIFs or exposure created through the use of financial derivative instruments. These exposures should not be excluded from the calculation of the total value of assets under management.

22. A compartment of an internally or externally managed AIF also has the option to exclude investments in another compartment of that AIF from the calculation of the threshold. This is because, on a look-through basis, there is only one set of underlying assets which should be included in assets under management. Leverage exposure must be included in the calculation of total assets under management.

23. In monitoring the total value of assets under management the AIFM should take into account subscription and redemption activity or where applicable capital drawdowns and capital distributions and, recent net asset value calculations for each AIF. The AIFM should also consider the types of AIFs under management and the different classes of assets invested in to assess whether the threshold may be exceeded and/or whether an additional calculation is needed. In considering whether an additional calculation is necessary the AIFM should consider how soon the next annual calculation will be carried out.

24. Article 3(3)(e) of the Directive requires Member States to ensure that AIFMs notify their competent authority in the event they no longer meet the conditions related to the thresholds. Article 3(3) further provides that these AIFMs must apply for authorisation within 30 calendar days. However the implementing measures referred to in Article 3(6) of the Directive recognise that exceeding or falling below the thresholds could occasionally occur within a given calendar year and acknowledge that these variations may not always result in the AIFM making an application for authorisation within 30 calendar days.

25. Paragraph 6 sets out a procedure which ensures that competent authorities are informed of each occasion when the threshold is breached but recognises that this need not result in the AIFM making an application for authorisation under the Directive. This process avoids potential situations where the AIFM may otherwise have felt obliged to withdraw an application in the event that the AIFM's total value of assets under management falls below the threshold within a given period which is temporary in nature.

26. When the total value of assets under management exceeds the threshold the AIFM must demonstrate to the competent authority that this situation is of a temporary nature and will not exceed three months. In making this assessment the AIFM should consider anticipated subscription and redemption activity or where applicable capital drawdowns and distribution. It is not appropriate for the AIFM to

use anticipated market movements as part of this assessment as these cannot be predicted with a sufficient degree of certainty.

27. The data used by AIFMs to calculate the total value of assets under management does not need to be available to the public or to investors. However, competent authorities must be able to verify that the AIFM's threshold calculations are accurate and must have access to this data if requested.

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

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

Q3: Do you consider that using the annual net asset value calculation is an appropriate measure for all types of AIF, for example private equity or real estate? If you disagree with this proposal please specify an alternative approach.

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

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

III.II. Influences of leverage on the assets under management

Extract from the Commission's request

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

Introduction

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

29. The AIFMD provides that the threshold must be calculated including assets under management acquired through use of leverage. Leverage is defined in the AIFMD 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'. In this regard ESMA is carrying out work in the context of other parts of its advice on the AIFMD that could be useful in establishing the methods of calculating the leverage employed and the method by which this leverage can be captured.

30. As the majority of respondents to the consultation supported a common definition and treatment of leverage in the Directive it is proposed that leverage is calculated for the purposes of the threshold using the gross method of calculating exposure set out in Box 95.

Box 2

Calculation of Leverage

1. The AIFM must include assets acquired through leverage when calculating the total value of assets under management.

2. AIFMs shall calculate leverage using the Gross method of calculating the exposure of the AIF as set out in Box 95.

Explanatory Text

31. For the purposes of paragraph 1 of Box 2, AIFMs should have regard to the methods of increasing the exposure of an AIF set out in Box 98.

Q6: Do you agree that AIFMs should include the gross exposure in the calculation of the value of assets under management when the gross exposure is higher than the AIF's net asset value?

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

Q8: Do you consider that the proposed requirements for calculating the total value of assets under management set out in Boxes 1 and 2 are clear? Will this approach produce accurate results?

III.III. Content of the obligation to register with national competent authorities and suitable mechanisms for gathering information

Extract from the Commission's request

CESR is requested to advise the Commission on the content of the obligation to register with national competent authorities for the entities described in Article 3(2).

CESR is requested to advise the Commission on suitable mechanisms for national competent authorities in order to gather information from these entities in order to effectively monitor systemic risk as set forth in Article 3(3). To that end, CESR is requested to specify the content, the format, and modalities of the transmission of the information to be provided to competent authorities. CESR is invited to consider the consistency with its advice regarding the Issue 25 (reporting obligations to competent authorities).

Introduction

32. ESMA is requested to advise the Commission on the content of the obligation to register with national competent authorities for the entities described in Article 3(2). Furthermore, ESMA is requested to advise the Commission on suitable mechanisms for national competent authorities to gather information from these entities in order to effectively monitor systemic risk as set forth in Article 3(3). To that end, ESMA is requested to specify the content, the format, and modalities of the transmission of the information to be provided to competent authorities.

33. As part of the registration process, an AIFM must contact its home competent authority and provide information on the following at the time of registration, in accordance with Article 3(3)(b) and (c) :

- its own identity;
- the AIFs it manages; and
- the investment strategies of these AIFs.

34. The AIFM must also provide its competent authority on a regular basis, in accordance with Article 3 (3)(d), with information on:

- the main instruments in which it is trading;
- the principal exposures; and
- the most important concentrations of AIFs it manages in order to enable the competent authorities to effectively monitor systemic risk.

35. The provisions in Box 3 should be read alongside those of Box 109, which sets out ESMA's detailed advice on the format and content of reporting to competent authorities. Given that the AIFMs that fall under Article 3(3) of the Directive will be managing smaller amounts of assets under management, however, it is important that the information collected is relevant from a systemic risk perspective and is not overly burdensome.

Proposed Advice

Box 3

Information to be provided as part of registration

In relation to the information provided to competent authorities as part of the registration process, the following is proposed:

1. Article 3(3)(b): The total value of assets under management calculated in accordance with the procedure set out in Boxes 1 and 2 should be included with the identity of the AIFs under man-

agement.

2. Article 3(3)(c): In order to provide updated information on the investment strategies of the AIFs, the AIFM may provide the offering document or a relevant extract from the offering document or a general description of the investment strategy. The description of the investment strategy should at least include the following information:

   - the main categories of asset in which the AIF will invest;
   - any industrial, geographic or other market sectors or specific classes of asset which are the focus of the investment strategy; and
   - a description of the AIF's borrowing or leverage policy.

3. Article 3(3)(d): Information collected in accordance with this article should be subject to the provisions of Article 50 of the AIFMD in relation to exchange of information between authorities.

4. The updated information referred to in this Article should be provided on a quarterly basis.

5. Competent authorities may require the AIFM to provide the information set out in paragraph 1 and 2 on a more frequent basis.

Explanatory Text

36. ESMA acknowledges that not all types of AIFM may have an up-to-date offering document and may find it more practical to specify the required information. For example, private equity or venture capital funds often raise money through negotiations with potential investors.

37. The Directive does not specify how regularly the information set out in Article 3(3)(d) should be provided. ESMA considers that it would be sufficient to provide this information at least on an annual basis.

38. The information required under Article 3(3)(d) will be subject to the pro forma reporting obligations set out in the Discussion Paper of the Task Force on transparency requirements.

III.IV. Opt-in procedure

Extract from the Commission's request

CESR is requested to advise the Commission on the procedures for AIFM which choose to opt-in under this Directive in accordance with Article 3(4). CESR should consider whether there are specific reasons not to use the same procedure that applies to AIFM that do not benefit from this exemption.

Introduction

39. ESMA is requested to advise the Commission on the procedures for AIFMs which choose to opt-in under the Directive in accordance with Article 3(4). ESMA should consider whether there are specific reasons not to use the same procedure that applies to AIFMs that do not benefit from this exemption

40. Article 7 of the AIFMD requires that each AIFM must apply to its home competent authority for authorisation and provide information relating to the AIFMs and the AIF under management specified in this Article. Article 7(4) provides that in the case of UCITS management companies, the competent authorities cannot require information or documents already submitted.

41. Subject to Article 3(3), which allows Member States to apply stricter rules, the decision to 'opt-in' to the AIFMD under Article 3(4) with respect to AIFMs falling below the thresholds rests solely with the AIFM. There appears to be no additional requirements with which the AIFM should be obliged to comply in order to opt-in to the AIFMD.

42. Most of the respondents to the call for evidence were of the view that the procedure for AIFMs which choose to opt-in under the Directive should be the same as for AIFMs that must comply with the AIFMD.

43. However, some stakeholders believed that the procedure should allow some flexibility and should be proportionate to the size of the AIFs.

Box 4

Opt-in Procedures

1. AIFMs that benefit from the exemption set out in Article 3 and that elect to seek authorisation under the AIFMD should contact their home competent authority and follow the procedure outlined in Articles 7 and 8.

2. AIFMs which were previously registered with a competent authority in accordance with the requirements of Article 3(2) and which elect for authorisation should submit all documents set out in Article 7, which have not been previously been submitted for registration purposes provided that there has been no material change to the information previously submitted. This is without prejudice to the position of UCITS management companies, to which the provisions of Article 7(4) apply as set out above.

Box 5

AIFMs falling below the threshold

1. An AIFM which is authorised in accordance with the Directive as a result of being above the threshold set out in Article 3(2) of the AIFMD who subsequently falls below this threshold should:

- consider notifying the competent authority that it intends to remain authorised under the AIFMD in accordance with the opt-in provisions; or

- demonstrate to the competent authority that it will remain below the threshold and seek revocation of its authorisation.

Explanatory Text

44. AIFMs which are authorised under the Directive and who fall below the threshold will continue to be authorised and do not have to make any notification to the competent authority unless they wish to be de-authorised. AIFMs may notify competent authorities that they have fallen below the threshold and are choosing to remain authorised under the opt-in provisions of the Directive.

IV. General operating conditions

Definitions

'**Capital commitment**' means the contractual commitment of an investor to provide the AIF with an agreed amount of capital on request by the AIFM.

'**Client**' means any natural or legal person or any other undertaking to which an AIFM provides services referred to in Article 6(4) of the AIFMD.

'**Collective portfolio management activities**' means the functions referred to in Annex I of the AIFMD.

'**Delegation**' means an arrangement of any form between an AIFM and a third party by which that third party performs a process, a service or an activity which would otherwise be undertaken by the AIFM itself.

'**Durable medium**' means any instrument which enables an investor to store information addressed personally to that investor in a way accessible for future reference for a period of time adequate for the purposes of the information and which allows the unchanged reproduction of the information stored.

'**Group**', in relation to an AIFM, means the group of which that AIFM forms a part, consisting of a parent undertaking, its subsidiaries and the entities in which the parent undertaking or its subsidiaries hold a participation, as well as undertakings linked to each other by a relationship within the meaning of Article 12(1) of Council Directive 83/349/EEC on consolidated accounts.

'**Originator'** means either of the following:

(a) an entity which, either itself or through related entities, directly or indirectly, was involved in the original agreement which created the obligations or potential obligations of the debtor or potential debtor giving rise to the exposure being securitised; or

(b) an entity which purchases a third party's exposures onto its balance sheet and then securitises them;

'**Relevant person**' means any of the following:

(a) a director, partner or equivalent, or manager of the AIFM;

(b) an employee of the AIFM, as well as any other natural person whose services are placed at the disposal and under the control of the AIFM and who is involved in the services of collective portfolio management by the AIFM;

(c) a natural or legal person who is directly involved in the provision of services to the AIFM under a delegation arrangement to third parties for the purpose of the provision of collective portfolio management by the AIFM.

'**Retention of net economic interest**' means:

(a) retention of no less than 5 % of the nominal value of each of the tranches sold or transferred to the investors;

(b) in the case of securitisations of revolving exposures, retention of the originator's interest of no less than 5% of the nominal value of the securitised exposures;

(c) retention of randomly selected exposures, equivalent to no less than 5 % of the nominal amount of the securitised exposures, where such exposures would otherwise have been securitised in the securitisation, provided that the number of potentially securitised exposures is no less than 100 at origination; or

(d) retention of the first loss tranche and, if necessary, other tranches having the same or a more severe risk profile than those transferred or sold to investors and not maturing any earlier than those transferred or sold to investors, so that the retention equals in total no less than 5 % of the nominal value of the securitised exposures;

'**Securitisation**' means a transaction or scheme, whereby the credit risk associated with an exposure or pool of exposures is tranched, having the following characteristics:

(a) payments in the transaction or scheme are dependent upon the performance of the exposure or pool of exposures; and

(b) the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme;

'**Securitisation position**' means an exposure to a securitisation;

'Senior management' means the person or persons who effectively conduct the business of an AIFM in accordance with Article 8(1)(c) of the AIFMD.

'**Sponsor**' means a credit institution other than an originator credit institution that establishes and manages an asset backed commercial paper programme or other securitisation scheme that purchases exposures from third party entities;

'**Supervisory function**' means the relevant persons or body or bodies responsible for the supervision of its senior management and for the assessment and periodical review of the adequacy and effectiveness of the risk management process and of the policies, arrangements and procedures put in place to comply with the obligations under the AIFMD.

'**Tranche**' means a contractually established segment of the credit risk associated with an exposure or number of exposures, where a position in the segment entails a risk of credit loss greater than or less than a position of the same amount in each other such segment, without taking account of credit protection provided by third parties directly to the holders of positions in the segment or in other segments;

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

Extract from the Commission's request

CESR is requested to provide the Commission with a description of the potential risks arising from professional negligence to be covered by additional own funds or the professional indemnity insurance referred to in Article 9(7).

CESR is requested to advise the Commission on how the appropriateness of additional own funds or the coverage of the professional indemnity insurance to cover appropriately the potential professional liability risks arising from professional negligence referred to in Article 9(7) should be determined, including – to the extent possible and appropriate – the methods to calculate the respective amounts of additional own funds or the coverage of the professional indemnity insurance.

CESR is requested to advise the Commission on the best way to determine ongoing adjustments of the additional own funds or of the coverage of the professional indemnity insurance referred to in Article 9(7).

Introduction

1. ESMA is requested to provide the Commission with a description of the types of risks arising from professional negligence. Furthermore ESMA is requested to advise on methods for calculating the respective amounts of additional own funds or the coverage of the professional indemnity insurance.

2. Many respondents to the call for evidence provided ESMA with instances of typical risks that could arise from professional negligence. Most of the risks relate to breaches of law and investment mandates or incorrect valuation. On the other hand, some respondents also highlighted that a static list would not provide flexibility, thereby suggesting determining high level risk groups. Moreover, some respondents provided a list of risks that are typically not covered by professional indemnity insurance, e.g. crime, investment performance or money laundering. All of these suggestions have been considered by ESMA when developing the description of potential risks arising from professional negligence.

3.With regard to the methods for calculating the respective amounts of additional own funds or professional indemnity insurance, none of the respondents to the call of evidence provided ESMA with a detailed calculation method. Respondents only suggested using the Insurance Mediation Directive or Article 7 of Directive 2006/49/EC as a starting point.

4. ESMA however decided neither to use the Insurance Mediation Directive nor Article 7 of Directive 2006/49/EC as a starting point because none of these provisions include a calculation method but rather set fixed amounts in figures. Moreover, risks arising from professional negligence by insurance intermediaries or firms covered under Article 7 of Directive 2006/49/EC may differ from those of AIFM. Therefore, ESMA believes that the Insurance Mediation Directive or Article 7 of Directive 2006/49/EC should not be used as a regulatory model for calculation methods for AIFM's professional indemnity insurance.

5. This advice provides two options for calculating additional own funds to cover potential liability risks. The first option is based on the variable assets under management (AuM). This option is already im-

plied in Article 9(3) of the AIFMD and in Article 7(1)(a)(i) of the UCITS Directive for the calculation of additional own funds referred to in those Articles. Option 1 is therefore based on an existing method and does not introduce a new one. Option 1 is also based on the assumption that liability risks rise with the value of the portfolios of AIFs managed by the AIFM. Option 2 additionally takes into account the variable income. The second option is therefore partially based on the approach taken in Directive 2006/48/EC, i.e. the Basic Indicator Approach, and includes the assumption that liability risks may not only rise with the value of the AIF's portfolios but also with the income of the AIFM. This component will correct for small size AIFM having higher income figures, which may be an indication for higher taken risks.

1. Description of potential risks

Box 6

Potential risks arising from professional negligence to be covered by additional own funds or professional indemnity insurance

1. The AIFM must be able to cover the potential liabilities arising from professional negligence.

2. The potential liability risks to be covered are the risk of losses arising from the activities of the AIFM for which the AIFM has legal responsibility. Those are particularly

   (a) Risks in relation to fraud:

   Losses due to dishonest, fraudulent or malicious acts by relevant persons.

   (b) Risks in relation to investors, products & business practices:

   Losses arising from a negligent failure to meet a professional obligation to specific investors and clients

   Those risks particularly include

   i. negligent loss of documents evidencing title of assets of the AIF

   ii. misrepresentations and misleading statements made to the AIF or its investors by the AIFM or relevant persons

   iii. negligent acts, errors or omissions by the AIFM resulting in a breach of:
      a. obligations according to law and regulatory framework
      b. duty of skill and care to the AIF when carrying out its professional activities
      c. obligations of confidentiality
      d. AIF rules or instruments of incorporation
      e. terms of its appointment by the AIF

   iv. improper valuation of assets and calculation of unit/share prices

   (c) Risks in relation to business disruption, system failures, process management:

   Losses arising from negligent failure resulting in or not adequate prohibiting the disruption of business or system failures, from failed transaction processing or process management

Explanatory Text

6. The risk to be covered under Article 9 (7) is 'professional liability risk' for liability arising from professional negligence. This is the risk that the AIFM can incur a liability to compensate a third party for its financial loss arising from the negligent performance by the AIFM of its professional duties. I.e., the risks to be covered are the risk of losses arising from the professional activities of the AIFM for which the AIFM has legal responsibility.

7. Paragraph 2 of Box 1 classifies potential loss events that may lead to liabilities of the AIFM and thus should be considered as liability risk. The three broad categories are followed by more detailed explanations on what should be particularly considered. However, the listed explanations are not exhaustive.

8. The first category is related to professional liability risk arising from fraud. The AIFM has the liability to prohibit by means of adequate internal control systems fraudulent behaviour within its organisation. Liabilities could arise as consequence of fraud within the AIFM. ESMA considers that professional liability arising from fraud practiced in the operational business by relevant persons (see the Definitions section above) should be covered.

9. The second category covers a wide range of potential liability risks in relation to the business and investors. For instance, liability might arise due to the AIFM losing documents of title to investments (such as losing share certificates issued by private companies), making misrepresentations, breaching its duty of care or breaching its duty of confidentiality. Other liabilities that potentially arise are particularly the negligent breach of the AIF rules that would also include the breach of the investment mandate. Moreover, negligently carrying out due diligence would also be considered as risk to be covered. If an AIFM negligently failed to carry out sufficient due diligence on an investment which turned out to be a fraud (e.g. a pyramid scheme such as the Madoff funds), the AIFM's liability to third parties must also be covered. This is of course distinct from the risk that the investment loses value due to adverse market conditions which must not be covered.

Q9: The risk to be covered according to paragraph 2 (b)(iv) of Box 6 (the improper valuation) would also include valuation performed by an appointed external valuer. Do you consider this as feasible and practicable?

2. Methods to calculate amounts of additional own funds or coverage of professional indemnity insurance (PII) and the determination of adjustments

Box 7

Qualitative Requirements (based on Annex X Directive Part 3 2006/48/EC)

1. The AIFM should implement effective internal operational risk management policies and procedures in order to identify, measure, manage and monitor appropriately operational risk including liability risks to which the AIFM is or could be reasonably exposed. The operational risk management activities shall be performed independently. For this purpose the AIFM

should, appropriate to the size and organisation of the AIFM and the nature, scale and complexity of its business, establish and maintain a separate operational risk management function in accordance with the requirements set out in Box 30.

2. Any operational failures and loss experience must be recorded and an historical loss database must be set up by the AIFM.

3. Within the risk management framework the AIFM should make use of its historical internal loss data and were appropriate of external data, scenario analysis and factors reflecting the business environment and internal control systems.

4. There must be regular internal reporting of operational risk exposures and loss experience.

5. The AIFM must have procedures for taking appropriate corrective action.

6. The AIFM's operational risk management policies and procedures must be well documented. The AIFM must have routines in place for ensuring compliance and policies for the treatment of non-compliance.

7. The operational risk management policies and procedures and measurement systems shall be subject to regular reviews.

8. The AIFM must maintain adequate financial resources. On the basis of the assessed risk profile, the AIFM has to ensure that liability risk arising from professional negligence are covered by own funds or professional indemnity insurance at all times.

Explanatory Text

10. Box 7 requires the implementation of appropriate internal control mechanism for operational risks including professional liability risk, as the mitigation of operational failures and liabilities is most relevant. This also includes, where appropriate to the size and organisation of the AIFM and the nature, scale and complexity of its business, the implementation of a separate operational risk management function which solves for independent internal oversights and the implementation of the four-eye principle to avoid that failures could be hidden. In this regard, the requirements in Box 30 should be considered.

11. The risk management policies and procedures should also include the building up of an internal loss database as basis for the assessment of the operational risk profile of the AIFM. Liability risk is considered to be part of operational risk and should therefore be taken into account in the operational risk management and control framework of the AIFM.

12. Moreover the requirements aim at a risk based approach. The AIFM itself is responsible to maintain sufficient financial resources adequate to its liability and operational risk profile. The AIFM may either cover the assessed liability risk arising from professional negligence by own funds or by professional indemnity insurance. If the AIFM assesses a lack between the own funds calculated according to Box 3 or the insurance cover according to Box 4 and its liability risk, the AIFM must compensate this difference by maintaining additional own funds or insurance cover with the assessed amount.

Box 8

Quantitative Requirements

1. Option 1:

   The additional own funds requirement for liability risk is equal to 0.01% of the value of the portfolios of AIF managed by the AIFM.

   Option 2:

   The additional own funds requirement for liability risk is equal to 0.0015% of the value of the portfolios of AIF managed by the AIFM plus 2% of the relevant income.

2. Relevant income is calculated considering the following requirements:

   (a) Relevant income is the sum of all income received in relation to the collective portfolio management activities of the AIFM subtracting the sum of commission and fees payable in relation to collective portfolio management activities calculated as average over three years;

   (b) The three-year average is calculated on the basis of the last three twelve-monthly observations at the end of the financial year. When audited figures are not available, paragraph 1 option 1 should be used;

   (c) If for any given observation, the sum of the income is negative or equal to zero, this figure shall not be taken into account in the calculation of the three-year average; however, if the sum of the last three years is negative or equal to zero, paragraph 1 option 1 should be used;

   (d) The relevant income is calculated as the sum of positive figures divided by the number of positive figures;

3. The own funds requirement is recalculated and adjusted if necessary at the end of each financial year.

4. Option 1

   The competent authority of the home Member State of the AIFM may authorize the AIFM to lower the percentage to 0.008%, provided that the AIFM can demonstrate -based on its historical loss data according to Box 2 and a minimum historical observation period of five years- that liability risk according to Box 1 is adequately captured. Conversely, the competent authority may rise the additional own funds requirements if they are not sufficient to capture liability risk arising from professional negligence.

   Option 2

   The competent authority of the home Member State of the AIFM may authorize the AIFM to lower the percentage in relation to relevant income to 1%, provided that the AIFM can demonstrate -based on its historical loss data according to Box 2 and a minimum historical observation period of five years- that liability risk according to Box 1 is adequately captured. Conversely, the competent authority may rise the additional own funds requirements if they are not sufficient to capture liability risk arising from professional negligence.

Explanatory Text

13. This Box provides for additional quantitative minimum requirements. Paragraph 1 and 2 set out the calculation methodology for the minimum amount of additional own funds. However, ESMA currently considers two options for the calculation of additional own funds.

14. According to paragraph 1, the additional own funds should be calculated as:

    Option 1:

    0.0001 x AuM,

    Option 2:

    0.000015 x AuM + 0.02 x relevant net income,

    where AuM are the assets under management, i.e., the value of the portfolios of AIF managed by the AIFM and relevant income is defined in paragraph 2 of Box 3.

15. The first option is solely based on the variable assets under management (AuM). This option is already implied in Article 9(3) of the AIFMD and in Article 7(1)(a)(i) of the UCITS Directive for the calculation of own funds referred to in those Articles. Option 1 is therefore based on an existing method and does not introduce a new one. Option 1 is also based on the assumption that liability risks rise with the value of the portfolios of AIFs managed by the AIFM.

16. Option 2 additionally takes into account the variable income. The second option is therefore partially based on the approach taken in Directive 2006/48/EC, i.e. the Basic Indicator Approach, and includes the assumption that liability risks (as part of operational risk) may not only rise with the value of the AIF's portfolios but also with the income of the AIFM. This component will correct for small size AIFM having higher income figures, which may be an indication for higher taken risks.

17. According to paragraph 2, relevant income is the sum of the income received subtracting the expenses for commission and fees based on the accounting categories for the profit and loss account. Only income and expenses in relation to the collective portfolio management activities as defined at the beginning of the report (means the functions referred to in Annex I of the AIFMD) should be considered (e.g., commission and fees receivable from managing AIFs, including performance fees). Hence, AIFM managing also UCITS must not take into account income and commission and fees expenses in relation to those activities.

18. By subtracting commission and fees payable the approach relies on Annex X Part 1 Table 1 of Directive 2006/48/EC, however adjusted for AIFM business, where interest rates payable as listed in Annex X Part 1 Table 1 of Directive 2006/48/EC are not in relation to the collective portfolio management activities, which are of interest here. Other operating expenses, e.g. personnel expenses, should not be subtracted.

19. While the approach is partially based on existing requirements with regards to Article 9 (3) of the AIFMD as own funds requirements rise with the assets under management, ESMA does not consider it as adequate to build on existing requirements in Article 9 (5) AIFMD as fixed overheads may not be an adequate approximation for the size of the AIFM and for professional liability risk.

20. The amounts are recalculated each financial year. That means, adjustments to own funds have to be made according to the recalculated amounts each year. To better incentive high efforts in operational risk management, the competent authority of the home member state of the AIFM may allow a lower percentage (but not less [option 1: 0.008% of AuM] [option 2: 1% of net income), if the AIFM can demonstrate that the lower amount adequately covers the liabilities based on historical data. This incentivises the implementation of adequate operational risk management systems according to Box 1. Contrary, historical loss data may also give rise to higher capital requirements than the calculated minimum according to paragraph 1. However, the calculated amount according to paragraph 1 is the minimum amount. In cases of higher liability risk exposures, the AIFM is not considered to comply with Box 2 if only the minimum amount according to paragraph 1 is captured, since paragraph 8 of Box 2 require that the AIFM must cover its liability risk exposure by sufficient own funds. The competent authorities may anyway higher the required additional own funds where they deem it necessary to cover the professional liability risk.

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

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

Q12: Please provide empirical evidence for liability risk figures, consequent own funds calculation and the implication of the two suggested methods for your business. When suggesting different number, please provide evidence for this suggestion.

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

Q14: Paragraph 4 of Box 8 provides that the competent authority of the AIFM may authorise the AIFM to lower the percentage if the AIFM can demonstrate that the lower amount adequately covers the liabilities based on historical loss data of five years. Do you consider this five-year period as appropriate or should the period be extended?

Box 9

Professional Indemnity Insurance

1. As an alternative to the requirements in Box 8 paragraph 1 regarding additional own funds, the AIFM may take out and maintain at all times professional indemnity insurance complying with the following requirements:

(a) The insurance policy must have an initial term of no less than one year;

(b) The cover provided by the policy is wide enough to include the liabilities of the AIFM and relevant persons;

(c) There are no exclusions regarding liability risks listed in Box 1;

(d) Any defined excess is covered by own funds;

(e) The insurance is taken out from an insurance undertaking authorized to transact professional indemnity insurance, which is subject to prudential regulation and ongoing supervision and has sufficient financial strength with regard to the claims paying ability In case of third country insurance undertakings, the AIFM has to demonstrate to the competent authority, that those requirements are fulfilled;

(f) The insurance is provided by a third party entity. In the case of insurance through affiliates, the exposure has to be laid off to an independent third party entity, for example through re-insurance, that meets the eligibility criteria;

2. The coverage of the insurance per claim must be adequate for the individual AIFM liability risk. The minimum coverage of the insurance for each claim must at least equal the higher of the following amounts:

(a) 0.75 % of the amount by which the value of the portfolios of the AIFM exceeds €250 million, up to a maximum of €20 million;

(b) €2 million.

3. The coverage of the insurance for claims in aggregate per year must be adequate for the individual AIFM liability risk. The minimum coverage of the insurance for all claims in aggregate per year must at least equal the maximum of the following amounts:

(a) 1 % of the amount by which the value of the portfolios of the AIFM exceeds €250 million up to a maximum of €25 million;

(b) €2.5 million;

(c) the amount calculated according to Box 8.

4. The AIFM should review the policy and its compliance with the requirements at least once a year and in the event of any change which affects compliance of the policy with the requirements.

Explanatory Text

21. Box 9 provides for requirements the professional indemnity insurance (PII) has to comply with to be deemed as equivalent coverage compared to own funds in Box 8.

22. Box 9 paragraph 1 defines a set of requirements for the insurance policy and the entity providing the PII. For the sake of reducing risk of insolvency of the insurance undertaking, the entity is required to be subject to prudential standards and supervision by a prudential regulator. Moreover, the AIFM must, by means of an adequate due diligence deem the financial strength of the insurance undertaking as sufficient.

23. Box 9 paragraph 2 and 3 set the requirements for the covered amounts the PII must provide. Generally, the coverage is subject to the risk assessment of the AIFM and of the insurance company and should be adequate to the risk AIFM face. Nevertheless, ESMA considers minimum amounts that must be covered. Those minimum amounts (for the single claims and for the claims in aggregate) are equal to the highest of the amounts outlined in (a) – (c).

24. Paragraphs 2 (a) and 3 (a) also tie in with Article 9(3) of the AIFMD and provide for an minimum amount in relation to the assets under management of the AIFM, hence, are again size dependent.

25. In line with the requirement in Article 7(ii) of the Directive 2006/49/EC, which imposes a fixed minimum amount per claim and in aggregate for the professional indemnity insurance requirements on certain MiFID investment firms, Box 9 paragraph 2 (b) and 3 (b) as well imposes fixed minimum coverages. However, minimum coverages are higher as a direct comparison with those certain MiFID firms is not adequate, particularly as those are not required to maintain additional own funds and according to AIFMD, the use of PII and own funds is equalized. Paragraph 3 (c) is the link to the amounts calculated according to Box 8. Overall, the minimum coverage may be higher than the amounts calculated as own funds requirement according to Box 8. This can be explained by higher uncertainty and risk in relation to the insurance coverage (e.g., higher legal and contract uncertainty, possible insolvency of the insurer) and aims to compensate this disadvantage.

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

IV.II. Possible Implementing Measures on General Principles

Extract from the Commission's request

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

The Commission would encourage CESR to target an appropriate level of consistency with the corresponding provisions of other directives, such as UCITS and MiFID, while taking due account of the differences between the regulated populations.

Introduction

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

2. The majority of respondents to the call for evidence published by CESR in December 2010 (Ref. CESR/10-1459) on possible implementing measures for the AIFMD took the view that an appropriate level of consistency with UCITS and MiFID should be targeted while the differences of the regulated entities are taken account of. Some respondents pointed out that many AIFM are already authorized under the UCITS or MiFID Directive. Furthermore, most of the respondents felt it important to take into account the professional nature of an AIF's investor and to bear in mind that UCITS standards relate to retail investors. A majority stressed the need for proportionately applying AIFMD Level 2 standards to the relevant business of the AIFM.

3.In line with the Commission's request and the majority of respondents to the call for evidence this advice seeks to achieve an appropriate level of consistency with the UCITS and MiFID regimes while taking into account the diversity of AIFs and different types of assets they are invested in. The 'conduct of business rules' of Article 12(1) of the AIFMD correspond to a large extent to the 'conduct of business rules' of Article 14(1) of the UCITS Directive. Therefore, ESMA believes that in order to specify the 'conduct of business rules' of Article 12(1) AIFMD, those provisions of the UCITS Level 2 that specify Article 14 UCITS Directive should serve as regulatory model.

4. However, as UCITS provisions are tailored for open-ended investment funds that generally invest in financial instruments, this advice provides adjustments or exemptions for those AIFs that are not open-ended and invest in other assets than financial instruments.

5.Additionally, ESMA took into account that UCITS provisions are aimed at the protection of retail investors while the AIFMD regulates the marketing of AIFs to professional investors. Also, since MiFID provisions often differentiate between retail and professional clients when it comes to the duties of investment firms, ESMA believes that sometimes the MiFID provisions are of greater utility for implementing measures: Whenever their articulation of duties is more liberal as the services are provided for professional clients rather than for retail clients, this advice is based on the respective MiFID provisions.

6. A further reason why ESMA believes that AIFMD's implementing measures should seek to achieve an appropriate level of consistency with the UCITS and MiFID regime is that many AIFM are already authorised as management companies under the UCITS Directive or are already operating under the MiFID regime. So in order to avoid the application of new or different regulatory standards to already regulated fund managers, ESMA advises to use UCITS and MiFID provisions as a regulatory model while taking due account of the diversity of AIFs.

Box 10

Duty to act in the best interests of the AIF or the investors of the AIF and the integrity of the market

1. AIFM should apply appropriate policies and procedures for preventing malpractices that might reasonably be expected to affect the stability and integrity of the market.

2. AIFM should act in such a way as to prevent undue costs being charged to the AIF and its investors.

Explanatory text

7. In line with the UCITS approach (Article 22 (2) and (4) UCITS Level 2) AIFM should take appropriate measures to avoid malpractices that might reasonably be expected to affect the stability and integrity of the market. Examples for such malpractices are market timing and late trading. Furthermore, AIFM should establish appropriate procedures and act in such a way as to prevent undue costs (e.g. excessive trading costs) being charged to the AIF and its investors.

Box 11

Due Diligence requirements

1. AIFM should ensure a high level of diligence in the selection and ongoing monitoring of investments, in the best interests of the AIF, its investors and the integrity of the market.

2. AIFM should ensure that they have adequate knowledge and understanding of the assets in which the AIF are invested.

3. AIFM should establish written policies and procedures on due diligence and implement effective arrangements for ensuring that investment decisions on behalf of the AIF are carried out in compliance with the objectives, investment strategy and, where applicable, risk limits of the AIF. The due diligence processes and procedures should be regularly reviewed and updated.

4. Where applicable to the type of asset, the AIFM should in addition to the requirements in paragraph 1 to 3

   (a) set out and update a business plan consistent with the duration of the AIF and market conditions;

   (b) seek and select possible transactions consistent with the plan referred to under point (a);

   (c) assess the selected transactions in consideration of opportunities, if any, and overall related risks, all relevant legal, fiscal, financial or other value affecting factors, human and material resources as well as strategies, including exit strategies;

   (d) perform any due diligence activities related to the transactions prior to arranging execution;

   (e) monitor the management performance of the AIF with respect to the plan referred to under

point (a).

5. AIFM should retain records on the activities performed pursuant to paragraph 4 for a period of at least five years.

Explanatory text

8. Paragraphs 1 to 3 contain general principles for due diligence AIFM have to comply with, irrespective of the assets in which the AIF is invested.

9. In line with the UCITS approach (Art. 23 UCITS Level 2) AIFM should ensure a high level of diligence in the selection and monitoring of investments. They should have the professional expertise and knowledge of the assets in which AIFs are invested. In order to ensure that investment decisions are carried out in compliance with the investment strategy and, where applicable, risk limits of the AIF, AIFM should establish and implement written policies and procedures on due diligence. These policies and procedures should be reviewed and updated on a regular basis.

10. Before an investment AIFM should carry out due diligence in order to ensure that the investment is in line with the AIF's investment strategy and in the best interest of the AIF and its investors. After an investment AIFM should periodically monitor the investment's conformity with the investment strategy and the best interest of the AIF and its investors.

11. Paragraphs 4 and 5 set out additional due diligence requirements AIFM have to comply with when investing on behalf of AIFs in specific types of assets: AIFM managing AIFs which invest in long duration, less liquid assets such as real estate or partnership interests, typically carry out the investments on behalf of the AIF after a comprehensive and detailed due diligence process and an extensive negotiation of the agreement. ESMA considers that the due diligence requirements apply also during the negotiation phase itself.

12. AIFM that invest on behalf of AIFs in such specific assets should set out a business plan consistent with the duration of the AIF and market conditions. They should update such a plan whenever material changes occur in relation to the investment strategy of the AIF or to market conditions.

13. Due diligence procedures should be proportionate to the type of asset in which the AIF is invested and to the nature, scale and complexity of the AIF.

14. The activities performed by the AIFM before closing an agreement should be well documented in order to demonstrate the consistency with the economic and financial plan and therefore with the duration of the AIF. In particular, AIFM should maintain minutes of the relevant meetings and of the preparatory documentation as well as of the economic and financial analysis conducted for assessing the feasibility of the project and the contractual commitment.

15. AIFM should also maintain evidence of significant investment opportunities, if any, preliminary examined for selecting the possible transactions e.g. a list of the visited companies belonging to a specific industrial market or a list of real estate visited by the AIFM. AIFM are not obliged to keep records of every investment opportunity examined or considered but only significant ones.

16. AIFM should deliver to its senior management the proposal to invest in a certain target company or real estate highlighting the advantages/ disadvantages and the exit strategy as well as any further proposal related to such an investment during the AIF's duration.

Q16: Paragraphs 4 and 5 of Box 11 set out additional due diligence requirements with which AIFMs must comply when investing on behalf of AIFs in specific types of asset e.g. real estate or partnership interests. In this context, paragraph 4(a) requires AIFMs to set out a 'business plan'. Do you agree with the term 'business plan' or should another term be used?

Box 12

Reporting obligations in respect of execution of subscription and redemption orders

1. Where AIFM have carried out a subscription or, where relevant, redemption order from an investor, they must promptly provide the investor, in a durable medium, with the essential information concerning the execution of that order.

2. AIFM shall supply the investor, upon request, with information about the status of the order.

Explanatory text

17. Since Article 40 MiFID Level 2 differentiates between retail and professional clients when it comes to the duty of reporting the execution of orders, Box 12 is based on Article 40(1)(a) MiFID Level 2 rather than Article 24 UCITS Level 2. According to Article 40 MiFID Level 2 the confirmation of the order execution to retail clients must contain more details than the one to professional clients. Since the AIFMD regulates marketing of AIFs to professional investors, Box 12 has been based on the MiFID Level 2 provision regulating the reporting obligations towards professional clients.

Box 13

Selection and appointment of counterparties and prime brokers

1. When selecting and appointing counterparties and prime brokers AIFM should exercise due skill, care and diligence prior entering into an agreement and on an ongoing basis by considering the full range and quality of their services. AIFM should ensure that counterparties and prime brokers are chosen which are subject to ongoing supervision by a public authority, are of financial soundness and have the necessary organisational structure for the services provided by them.

2. For the purpose of paragraph 1 AIFM should maintain a list of the appointed prime brokers approved by senior management. Only in exceptional cases and subject to approval by senior management the AIFM may appoint prime brokers not included in the list. The AIFM should demonstrate the reasons for such a choice and the diligence that it exercised in selecting and monitoring these prime brokers.

3. For the purpose of this Box, counterparty means a counterparty of an AIFM in an OTC transaction, in a securities lending or in a repurchase agreement.

Explanatory text

18. Box 13 requires AIFM to exercise due skill, care and diligence when selecting and appointing counterparties and prime brokers. While the term 'prime broker' is defined in Article 4(1)(z)(af) of the AIFMD, there is no definition of the term 'counterparty' in the AIFMD. Therefore, paragraph 3 of Box 13 sets out a definition of 'counterparty': For the purpose of this Box 'counterparty' should mean a counterparty of an AIFM in an OTC transaction, in a securities lending or in a repurchase agreement. The term 'OTC transaction' refers to over-the-counter trading (in contrast to stock exchange trading) with financial instruments such as derivatives, bonds or securities.

19. The selection of counterparties and prime brokers should be based on certain criteria: these entities should be subject to ongoing supervision by a public authority, they should be of financial strength and they should have the necessary organisational structure for the services provided by them. However, this does not prevent AIFM from using additional criteria for the selection of counterparties and prime brokers.

Box 14

Execution of decisions to deal on behalf of the managed AIF

1. AIFM should act in the best interest of the AIF or the investors of the AIF they manage when executing decisions to deal on behalf of the managed AIF in the context of the management of their portfolio.

2. Whenever AIFM buy or sell financial instruments or other assets and for the purpose of paragraph 1, AIFM should take all reasonable steps to obtain the best possible result for the AIF or the investors of the AIF, taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order. The relative importance of such factors shall be determined by reference to the following criteria:

   (a) the objectives, investment policy and risks specific to the AIF, as indicated in the fund rules or article of association, prospectus or offering documents of the AIF;

   (b) the characteristic of the order;

   (c) the characteristics of the financial instruments or other assets that are the subject of that order;

   (d) the characteristics of the execution venues to which that order can be directed.

3. AIFM should establish and implement effective arrangements for complying with the obligation referred to in paragraph 2. In particular, AIFM should establish and implement a written policy to allow them to obtain, for AIF orders, the best possible result in accordance with paragraph 2.

4. AIFM shall monitor on a regular basis the effectiveness of their arrangements and policy for the execution of orders in order to identify and, where appropriate, correct any deficiencies.

   In addition, AIFM should review the execution policy on an annual basis. A review should also be carried out whenever a material change occurs that affects the AIFM's ability to continue to obtain the best possible result for the managed AIF.

5. AIFM should be able to demonstrate that they have executed orders on behalf of the AIF in accordance with the AIFM's execution policy.

6. Whenever there is no choice of different execution venues, AIFM should not be obliged to comply with paragraph 2 to 5. AIFM should be able to demonstrate that there is no choice of different execution venues.

Explanatory text

20. Management companies managing UCITS must already comply with best execution rules according to Article 25 UCITS IV Level 2. Also management companies and AIFM that provide the service of individual portfolio management have to comply with the MiFID best execution rules pursuant to Article 21 of MiFID and Articles 44 to 46 of the MiFID Level 2 Directive.Therefore it seems reasonable that investors of AIFs benefit from similar protections. Nevertheless, the differences between the various types of assets in which AIFs are invested should be taken into account.

21. While paragraph 1 applies to all types of AIF, paragraphs 2 to 5 only apply to those types of AIF which acquire or sell financial instruments or other assets for which best execution is relevant. Best execution is not relevant when the AIFM, for example, invests in real estate or partnership interests and the investment is made after extensive negotiations on the terms of the agreement. In this case there is no choice of different execution venues and the requirements of paragraph 2 to 5 are not applicable. The AIFM should be able to demonstrate to the competent authority and auditors that there is no choice of different execution venues.

Box 15

Placing orders to deal on behalf of AIFs with other entities for execution

1. Whenever AIFM buy or sell financial instruments or other assets, they should act in the best interests of the AIF they manage when placing orders to deal on behalf of the managed AIF with other entities for execution, in the context of the management of their portfolio.

2. AIFM should take all reasonable steps to obtain the best possible result for the AIF or the investors of the AIF taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order. The relative importance of such factors should be determined by reference to B. 5 paragraph 2.

   For those purposes, AIFM should establish and implement a policy to enable them to comply with the obligation referred to in the first subparagraph. The policy should identify, in respect of each class of instruments, the entities with which the orders may be placed. AIFM should only enter into arrangements for execution where such arrangements are consistent with obligations laid down in this box. AIFM should make available to investors appropriate information on the policy established in accordance with this box and on any material changes to this policy.

3. AIFM should monitor on a regular basis the effectiveness of the policy established in accordance with paragraph 2 and, in particular, the execution qualities of the entities identified in that policy and, where appropriate, correct any deficiencies.

   In addition, AIFM should review the policy on an annual basis. Such a review shall also be carried out whenever a material change occurs that affects the AIFM's ability to continue to obtain the best possible result for the managed AIF.

4. AIFM should be able to demonstrate that they have placed orders on behalf of the AIF in accordance with the policy established in accordance with paragraph 2.

5. Whenever there is no choice of different execution venues, AIFM should not be obliged to comply with paragraph 2 to 4. AIFM should be able to demonstrate that there is no choice of different execution venues.

Explanatory text

22. AIFM may either directly execute orders to deal on behalf of the managed AIF or place such orders with other entities for execution. While Box 14 deals with the first situation, Box 15 covers the latter.

23. In line with the UCITS approach (Article 26 UCITS Level 2) AIFM should not only act in the best interest of the AIF they manage when they directly execute decisions to deal but also when they place orders with other entities for execution.

24. While paragraph 1 applies to all types of AIF, paragraphs 2 to 4 only apply to those types of AIF which buy or sell financial instruments or other assets for which best execution is relevant. Best execution is not relevant when the AIFM, for example, invests in real estate or partnership interests and the investment is made after extensive negotiations on the terms of the agreement. In this case there is no choice of different execution venues and the requirements of paragraphs 2 to 4 are not applicable. The AIFM should be able to demonstrate to the competent authority and auditors that there is no choice of different execution venues.

Box 16

Handling of orders – general principles

1. AIFM should establish and implement procedures and arrangements which provide for the prompt, fair and expeditious execution of orders on behalf of the AIF.

   The procedures and arrangements implemented by AIFM should satisfy the following conditions:

   (a) ensure that orders executed on behalf of AIFs are promptly and accurately recorded and allocated;

   (b) execute otherwise comparable AIF orders sequentially and promptly unless the characteristics of the order or prevailing market conditions make this impracticable, or the interests of the AIF or of the investors of the AIF require otherwise.

   AIFM should ensure that financial instruments, sums of money or other assets, received in settlement of the executed orders are promptly and correctly delivered to or registered in the account of the appropriate AIF.

2. AIFM should not misuse information relating to pending AIF orders, and shall take all reasonable steps to prevent the misuse of such information by any of its relevant persons.

Explanatory text

25. Management companies managing UCITS must already comply with general principles for the handling of orders (Article 27 UCITS IV Level 2). ESMA believes that such rules should also apply to AIFM when providing collective portfolio management. For the purpose of this Box 'order' means any trading order in relation to the portfolio of the AIF e.g. an order to buy or sell financial instruments such as securities, bonds or derivatives. Box 16 does not apply where the investment in assets is made after exten-

sive negotiations on the terms of the agreement (e.g. investment in real estate, partnership interests or non-listed companies) because in these cases no 'order' will be executed. When investing in these types of asset, AIFMs have to comply with specific due diligence requirements (see Box 11, Due Diligence requirements).

26. In line with the UCITS approach ESMA advises not to adopt Article 47(1)(a) MiFID Level 2 which requires the investment firm to inform a retail client about any material difficulty relevant to the proper carrying out of orders promptly upon becoming aware of the difficulty. The equivalent of a retail client in this context would be the AIF.

Box 17

Aggregation and allocation of trading order

1. AIFM should not be permitted to carry out an AIF order in aggregate with an order of another AIF, a UCITS or a client or with an order made when investing their own funds, unless the following conditions are met:

   (a) it must be unlikely that the aggregation of orders will work overall to the disadvantage of any AIF, UCITS or clients whose order is to be aggregated;

   (b) an order allocation policy must be established and implemented, providing in sufficiently precise terms for the fair allocation of aggregated orders, including how the volume and price of orders determines allocations and the treatment of partial executions.

2. Where an AIFM aggregates an AIF order with one or more orders of other AIFs, UCITS or clients and the aggregated order is partially executed, it should allocate the related trades in accordance with its order allocation policy.

3. AIFM which have aggregated transactions for own account with one or more AIFs, UCITS or clients' orders should not allocate the related trades in a way that is detrimental to the AIF or a client.

4. If an AIFM aggregates an order of an AIF, UCITS or another client with a transaction for own account and the aggregated order is partially executed, it allocates the related trades to the AIF or to clients in priority over those for own account.

   However, if the AIFM is able to demonstrate to the AIF or to the client on reasonable grounds that it would not have been able to carry out the order on such advantageous terms without aggregation, or at all, it may allocate the transaction for own account proportionally, in accordance with the policy as referred to in paragraph 1(b).

Explanatory text

27. Management companies managing UCITS must already comply with rules on aggregation and allocation of trading orders (Article 28 UCITS IV Level 2). ESMA believes that such rules should also apply to AIFM when providing collective portfolio management. For the purpose of this Box 'order' means any trading order in relation to the portfolio of the AIF, e.g. an order to buy or sell financial instruments such as securities, bonds or derivatives. Box 7 does not apply where the investment in assets is made after extensive negotiations on the terms of the agreement (e.g. investment in real estate, partnership interests or non-listed companies) because in this cases no 'order' will be executed. For the investment

in these types of assets AIFM have to comply with specific due diligence requirements (see Box 11 on Due Diligence requirements).

28. In line with the UCITS approach ESMA advises not to adopt Article 48(1)(b) MiFID Level 2 which requires the investment firm to disclose to each client whose order is to be aggregated that the effect of aggregation may work to its disadvantage in relation to a particular order. The equivalent of a retail client in this context would be the AIF.

Box 18

Inducements

1. AIFM should not be regarded as acting honestly, fairly and professionally in accordance with the best interests of the AIF if, in relation to the activities of collective portfolio management of AIFs (activities referred to in Annex I), they pay or are paid any fee or commission, or provide or are provided with any non-monetary benefit, other than the following:

   (a) a fee, commission or non-monetary benefit paid or provided to or by the AIF or a person on behalf of the AIF;

   (b) a fee, commission or non-monetary benefit paid or provided to or by a third party or a person acting on behalf of a third party, where the AIFM can demonstrate that the following conditions are satisfied:

      (i) the existence, nature and amount of the fee, commission or benefit, or, where the amount cannot be ascertained, the method of calculating that amount, must be clearly disclosed to the investors of the AIF in a manner that is comprehensive, accurate and understandable, prior to the provision of the relevant service;

      (ii) the payment of the fee or commission, or the provision of the non-monetary benefit must be designed to enhance the quality of the relevant service and not impair compliance with the AIFM's duty to act in the best interests of the AIF.

   (c) proper fees which enable or are necessary for the provision of the relevant service, including custody costs, settlement and exchange fees, regulatory levies or legal fees, and which, by their nature, cannot give rise to conflicts with the AIFM's duties to act honestly, fairly and professionally in accordance with the best interests of the AIF.

2. AIFM should be permitted, for the purpose of paragraph 1(b)(i), to disclose the essential terms of the arrangements relating to the fee, commission or non-monetary benefit in summary form, provided that the AIFM undertakes to disclose further details at the request of the investor and provided that it honours that undertaking.

Explanatory text

29. Management companies managing UCITS must already comply with inducements rules according to Article 29 UCITS Level 2. Also management companies and AIFM that provide the service of individual portfolio management have to comply with MiFID inducement rules according to Article 26 MiFID. ESMA advises that these principles should also apply to AIFM that provide the service of collective portfolio management.

30. Box 18 relates to all functions of collective portfolio management and therefore also to marketing. In contrast Article 29 UCITS Level 2 only refers to activities of investment management and administration but not to marketing. Marketing fees have not been included in the UCITS provision at this time because of the Packaged Retail Investment Products (PRIPs) initiative which will cover such fees. However, since PRIPs will not apply to AIFMs marketing AIFs to professional investors, ESMA recommends having inducement rules in relation to all functions of collective portfolio management. The following example should illustrate the approach considered in Box 18: where an investor pays subscription fees to an AIFM which are passed on to intermediaries for the marketing of the relevant AIF, the payment falls under paragraph 1(b) of Box 18.

31. ESMA is aware that on December 8, 2010 the EU Commission launched a consultation on the review of MiFID and particularly proposed amendments to inducements rules e.g. excluding the possibility of providing a summarised disclosure concerning inducements. ESMA decided not to prejudge the final outcome of the MiFID review and therefore not to include any of the amendments proposed in the consultation at this time.

32. Finally, ESMA believes that the existence, nature and amount of the fee, commission or benefit, or, where the amount cannot be ascertained, the method of calculating that amount, should also be disclosed in the annual report.

Box 19

Fair treatment by an AIFM

Option 1

Fair treatment by an AIFM requires that no investor may obtain a preferential treatment that has an overall material disadvantage to other investors.

Option 2

Fair treatment by an AIFM includes that no investor may obtain a preferential treatment that has an overall material disadvantage to other investors.

Explanatory text

Option 1

33. ESMA believes that fair treatment of AIF investors requires that no investor may obtain a preferential treatment that has an overall material disadvantage to other investors. Consequently, preferential treatment of one investor does not necessarily means that it has an overall material disadvantage to other investors. However, if a preferential treatment has such an effect, it would be an unfair treatment and therefore not be allowed. In contrast, preferential treatment that has no overall material disadvantage to other investors is allowed if this is disclosed in the relevant AIF's rules or instruments of incorporation (Article 12(1) subpara. 2 of the AIFMD).

34. If an AIF offers different share classes, in particular with regard to the redemption deduction, the minimum investment amount or the management fees, there is a preferential treatment of the investors of one share class (e.g. granting a higher redemption deduction) over investors of another share

class. However, this would not be an unfair treatment as the preferential treatment of the investors of one share class has no overall material disadvantage to investors of another share class.

35. Furthermore, it is not unfair either to grant preferential treatment to seed investors as this generally has no overall material disadvantage to investors that join the fund later where seed investors take an additional investment risk in relation to the start up – unlike the following investors.

36. ESMA considers that there are different methods to prevent an unfair treatment of investors, e.g. the so-called 'most favoured nation clause'. According to the November 2010 IOSCO report 'Private Equity Conflicts of Interest'[11] (page 10) '*Private equity funds are sometimes established subject to a most favoured nation clause which may provide less influential investors with the ability to benefit from more favourable terms negotiated by larger investors, thereby providing consistency among all investors, although in many instances an investor's most favoured nation rights are limited to terms of those investors with an equal or smaller commitment.*'

37. An unfair treatment would also be prevented in the following example: An investor obtains preferential treatment at a time other investors have already invested in the AIF. There is no 'most favoured nation clause' but these other investors are informed of the preferential treatment and have the right to redeem their shares or units free of cost.

Option 2

38. ESMA acknowledges the request from the European Commission to provide advice on the criteria to be used by the relevant competent authorities to assess whether AIFM comply with certain obligations under the Directive, including in this respect treating all AIF investors fairly.

39. ESMA also acknowledges the need expressed by the Commission to target an appropriate level of consistency with the corresponding provisions of other directives including UCITS and MiFID. In this regard ESMA acknowledges that while these other directives impose obligations on firms to act fairly and in accordance with the best interests of their clients, neither the directives nor their implementing measures contain a definition of fair treatment.

40. ESMA acknowledges that most, if not all, of the national regulatory frameworks under which competent authorities currently operate already contain a principle of fair treatment. However, the concept of fair treatment necessarily contains an element of objectivity which takes account of the facts of a particular circumstance or case. Whilst ESMA believes it is appropriate to respond to the Commission's request for advice in establishing the criteria to be used by competent authorities in assessing fair treatment, it also believes that it is not appropriate to provide a maximum harmonising definition of fair treatment.

41. ESMA has reached this view because setting out a maximum harmonising definition of fair treatment, even cast at a principle level, will inevitably not enable competent authorities to comprehensively deal with all issues in which the actions of an AIFM on fairness grounds are called into question. As such introducing a strict definition of fair treatment may weaken rather than strengthen investor protection by imposing barriers which prevent competent authorities taking action (e.g. if in accordance with

[11] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD341.pdf

option 1 the competent authority cannot demonstrate that there has been a material overall disadvantage to investors if will not be able to act on fairness grounds).

42. ESMA therefore believes that it is appropriate to indicate that fair treatment may include that no investor may obtain a preferential treatment that has a material overall disadvantage to other investors, but not provide a definition which comprehensively defines fairness.

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

IV.III. Possible Implementing Measures on Conflicts of Interest

Extract from the Commission mandate

1. *CESR is requested to provide the Commission with a description of the types of conflicts of interests between the various actors as referred to in Article 14(1).*

2. *CESR is requested to advise the Commission on the reasonable steps an AIFM should be expected to take in terms of structures and organisational and administrative procedures in order to identify, prevent, manage, monitor and disclose conflicts of interest.*

3. *The Commission would encourage CESR to target an appropriate level of consistency with the corresponding provisions of other directives, such as UCITS and MiFID, while taking due account of the differences between the regulated populations.*

Introduction

1. ESMA is requested to provide the Commission with a description of the types of conflicts of interest between the various actors as referred to in Article 14(1) of the AIFMD. Furthermore, ESMA is requested to advise the Commission on reasonable steps an AIFM should be expected to take. These steps must be defined in terms of structures and organisational and administrative procedures in order to identify, prevent, manage, monitor and disclose conflicts of interest.

2. Respondents to the call for evidence suggested using the MiFID and UCITS regulatory framework as a starting point for the description of types of conflicts of interest as well as for the identification and management of such conflicts of interest.

3. With regard to the description of the types of conflicts of interest ESMA took into account that UCITS Level 2 and MiFID Level 2 already set out situations in which conflicts of interest may arise. This advice is based on these Level 2 provisions and describes situations in which conflicts of interest may arise. ESMA believes it is useful to give some examples for specific conflicts of interest and has therefore included a list of examples in the **Explanatory text**. Some of the examples are taken from the November 2010 IOSCO report 'Private Equity Conflicts of Interest'[12].

4. As for the steps an AIFM should be expected to take in order to identify, prevent, manage, monitor an disclose conflicts of interest, the advice also recommends consistency with the regulatory framework for UCITS Level 2 and MiFID Level 2.

Box 20

Types of conflicts of interest between the various actors as referred to in Article 14(1)

[12] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD341.pdf

For the purpose of identifying the types of conflicts of interest that arise in the course of managing AIFs, AIFM should take into account, by way of minimum criteria, the question of whether the AIFM, a relevant person or a person directly or indirectly linked by way of control to the AIFM

(a) is likely to make a financial gain, or avoid a financial loss, at the expense of the AIF or its investors;

(b) has an interest in the outcome of a service or an activity provided to the AIF or its investors or to a client or of a transaction carried out on behalf of the AIF or a client, which is distinct from the AIF interest in that outcome;

(c) has a financial or other incentive to favour (i) the interest of a UCITS, a client or group of clients or another AIF over the interest of the AIF or (ii) the interest of one investor over the interest of another investor or group of investors of the same AIF;

(d) carries on the same activities for the AIF and for another AIF, a UCITS or client; or

(e) receives or will receive from a person other than the AIF or its investors an inducement in relation to collective portfolio management activities provided to the AIF, in the form of monies, goods or services other than the standard commission or fee for that service.

Explanatory text

5. Box 20 is based on Article 17 UCITS Level 2 and sets out by way of minimum criteria five situations in which conflicts of interest between the various actors as referred to in Article 14(1) of the AIFMD might arise.

6. Below examples of conflicts of interest are given for each of the situation set out in the Box. Some of these are based on the November 2010 IOSCO report 'Private Equity Conflicts of Interest' ('IOSCO Report').

7. Examples for the situation under (a) ('The AIFM, a relevant person or a person directly or indirectly linked by way of control to the AIFM is likely to make a financial gain, or avoid a financial loss, at the expense of the AIF or its investors'):

- As for so-called 'private equity funds' the final size of the fund is usually agreed during the fund raising process between the AIFM and the investors. However, in case no 'hard cap' limit of the fund size is agreed, the following conflict of interest may arise: If the management fee is calculated as a percentage of the total amount of committed capital, an increase of the size limit of the AIF without any advantage for the investors of the AIF (e.g. no attractive investment possibilities) may rather serve the interests of the manager than the investors' one.

- AIF invests in assets (e.g. real estate or securities) the owner or issuer of which is either a relevant person or a person directly or indirectly linked by way of control to the AIFM and the investment is to the disadvantage of the AIF or its investors (e.g. bad location or high transaction costs).

- AIFM delegates activities (e.g. property and facility management of a real estate fund) to a member of the group to the detriment of the AIF or its investors (for instance when the delegate is a poor provider).

- AIFM extends the statutory life of an AIF in order to gain ongoing charges.

8. Examples for the situation under (b) ('The AIFM, a relevant person or a person directly or indirectly linked by way of control to the AIFM has an interest in the outcome of a service or an activity provided to the AIF or its investors or to a client or of a transaction carried out on behalf of the AIF or a client, which is distinct from the AIF interest in that outcome'):

   - Assets (e.g. real estate) held by the AIF have been purchased from or sold to relevant persons or persons directly or indirectly linked by control to the AIFM. In this case such person has an interest in the sale or purchase that is distinct from the interest of the AIF as a purchaser or a seller (e.g. asset is overpaid or real estate is in a bad location).

   - AIFM appoints a real estate provider that is a person directly or indirectly linked by way of control to the AIFM. The appointment is to the detriment of AIF investors if the provider is not the most efficient cost provider.

   - AIFM invests in a target company which has been provided with a loan by a relevant person or a person directly or indirectly linked by control to the AIFM. In this case the AIFM may be influenced by the interest of the relevant person in avoiding financial distress of the target company.

   - The AIFM uses broker services which are provided by a relevant person or a person with whom a relevant person has a family relationship.

   - AIFM appoints an advisor for selecting investment opportunities (e.g. for investing in other funds) that is a relevant person or person directly or indirectly linked by way of control to the AIFM.

   - AIFM selects a counterparty for an OTC-transaction (e.g. derivatives, securitisation) that is a relevant person or person directly or indirectly linked by way of control to the AIFM or is a member of the group.

9. Examples for the situation under (c) ('The AIFM, a relevant person or a person directly or indirectly linked by way of control to the AIFM has a financial or other incentive to favour (i) the interest of a UCITS, a client or group of clients or another AIF over the interest of the AIF or (ii) the interest of one investor over the interest of another investor or group of investors of the same AIF.'):

   - An AIFM reduces staff from a poorly performing AIF in favour of another, better performing AIF.

   - The AIFM grants an investor 'co-investment rights' that differ in terms from those offered to other AIF investors.

   - A conflict of interest may also arise if the AIFM buys or sells on behalf of the AIF an asset from/to one investor of the AIF, especially if the asset is not negotiated in a regulated market (e.g. non listed company for a private equity AIF or property for a real estate AIF).

- Follow-on or rescue financing for a portfolio company that is being provided by a second AIF managed by the same AIFM. This can occur when the first AIF has exhausted its investment capital.

- An AIFM manages both an AIF and a UCITS while the AIF has a long position and the UCITS a short one in the same asset. If the AIFM has the possibility to influence the value of this asset because the AIF has a large position relative to market volume, a conflict of interest may arise.

- By special arrangement (so-called 'side-letter'), the AIFM grants an investor redemption rights that are preferential in terms from the general redemption rights given to other investors.

10. Examples for the situation under (d) ('The AIFM, a relevant person or a person directly or indirectly linked by way of control to the AIFM carries on the same activities for the AIF and for another AIF, a UCITS or client.'):

- An AIFM sets up a new AIF with the same or similar strategy of an AIF that has not been fully invested yet and allocates investment opportunities to the new AIF instead of to the preceding AIF.

- Cross trades between two AIFs or between an AIF and a UCITS on terms that put one of the parties at a disadvantage.

11. Examples for the situation under (e) ('The AIFM, a relevant person or a person directly or indirectly linked by way of control to the AIFM receives or will receive from a person other than the AIF or its investors an inducement in relation to collective portfolio management activities provided to the AIF, in the form of monies, goods or services other than the standard commission or fee for that service'):

- AIFM that has invested in a portfolio company and receives form this portfolio company on an ongoing basis fees such as directors' fees, monitoring fees or consultancy fees.

- Soft commission agreements with brokers, target AIFs or target companies. For instance the AIFM appoints brokers from whom it receives goods or services (e.g. financial research or data) in exchange for placing of orders.

Box 21

Conflicts of interest policy

1. AIFM should establish, implement and maintain an effective conflicts of interest policy. That policy shall be set out in writing and shall be appropriate to the size and organisation of the AIFM and the nature, scale and complexity of its business.

   Where the AIFM is a member of a group, the policy should also take into account any circumstances of which the AIFM is or should be aware which may give rise to a conflict of interest resulting from the structure and business activities of other members of the group.

2. The conflicts of interest policy established in accordance with paragraph 1 shall include the following:

   (a) the identification of, with reference to the activities carried out by or on behalf of AIFM including activities carried out by a delegate, sub-delegate, external valuer or counterparty, the circumstances which constitute or may give rise to a conflict of interest

entailing a material risk of damage to the interests of the AIF or its investors;

(b) procedures to be followed and measures to be adopted in order to manage such conflicts.

Explanatory text

12. In line with the UCITS (Article 18 UCITS Level 2) and the MiFID (Article 22(1)-(2) MiFID Level 2) approach AIFM should establish, implement and maintain a conflicts of interest policy.

13. This policy should identify situations under which activities carried out by the the AIFM may constitute conflicts of interest followed by potential risks of damage to the AIF's interests or its investors. For this identification the AIFM should not only take into account the activity of collective portfolio management but also other activities it is authorised to carry out pursuant to Art. 6(2) and (4) of the AIFMD. Also the AIFM should consider activities carried out by a delegate, sub-delegate, external valuer or counterparty when identifying circumstances that could constitute conflicts of interest.

Box 22

Independence in conflicts management

1. The procedures and measures provided for the management of conflicts of interest should be designed to ensure that relevant persons engaged in different business activities involving a conflict of interest carry on these activities at a level of independence appropriate to the size and activities of the AIFM and of the group to which it belongs, and to the materiality of the risk of damage to the interests of the AIF or its investors.

2. The procedures to be followed and measures to be adopted in accordance with paragraph 2(b) of Box 2 shall include the following where necessary and appropriate for the AIFM to ensure the requisite degree of independence:

   (a) effective procedures to prevent or control the exchange of information between relevant persons engaged in collective portfolio management activities or other activities pursuant to Article 6(2) and (4) AIFMD involving a risk of a conflict of interest where the exchange of the information may harm the interest of one or more AIFs or its investors;

   (b) the separate supervision of relevant persons whose principal functions involve carrying out collective portfolio management activities on behalf of, or providing services to clients or to investors whose interest may conflict, or who otherwise represent different interests that may conflict, including those of the AIFM;

   (c) the removal of any direct link between the remuneration of relevant persons principally engaged in one activity and the remuneration of, or revenues generated by, different relevant persons principally engaged in another activity, where a conflict of interest may arise in relation to those activities;

   (d) measures to prevent or limit any person from exercising inappropriate influence over the way in which a relevant person carries out collective portfolio management activities;

   (e) measures to prevent or control the simultaneous or sequential involvement of a relevant person in separate collective portfolio management activities or other activities pursuant to Article 6(2) and (4) AIFMD where such involvement may impair the proper

management of conflicts of interest.

Where the adoption or the practice of one or more of those measures and procedures does not ensure the requisite degree of independence, AIFM should adopt such alternative or additional measures and procedures as are necessary and appropriate for those purposes.

Explanatory text

14. In line with the approach considered in UCITS (Article 19 UCITS Level 2) and MiFID (Article 22(3) MiFID Level 2) AIFM should adopt procedures and measures to ensure that relevant persons engaged in different business activities that could involve conflicts of interest carry out these activities on an appropriately independent level. This level should be in proportion to the size and organisation of the AIFM and the nature, scale and complexity of its business.

Box 23

Record keeping of activities giving rise to detrimental conflicts of interest and way of disclosure of conflicts of interest

1. AIFM should keep and regularly update a record of the types of activities undertaken by or on behalf of the AIFM in which a conflict of interest entailing a material risk of damage to the interests of one or more AIFs or its investors has arisen or, in the case of an ongoing activity, may arise.

2. The AIFM shall disclose to investors by a durable medium or by means of a website (where that does not constitute a durable medium) provided that the conditions specified in paragraph 3 are satisfied

   (a) conflicts of interest pursuant to Article 14(1) and (2) of the AIFM Directive, and

   (b) where a delegation or sub-delegation of portfolio or risk management has taken place, conflicts of interest between the delegate or sub-delegate and the AIFM or the investors of the respective AIF .

3. Where an AIFM provides information to an investor by means of a website and that information is not addressed personally to the investor, the AIFM should ensure that the following conditions are satisfied:

   (a) there is evidence that the investor has regular access to the internet. The provision by the investor of an e-mail address shall be treated as such evidence;

   (b) the investor must specifically consent to the provision of that information in that form;

   (c) the investor must be notified electronically of the address of the website, and the place on the website where the information may be accessed;

   (d) the information must be up to date;

   (e) the information must be accessible continuously by means of that website for such period of time as the investor may reasonably need to inspect it.

Explanatory text

15. In line with Article 20(1) UCITS Level 2 and Article 23 MiFID Level 2 AIFM should keep and regularly update a record of the types of activities undertaken by or on behalf of the AIFM in which a conflict of interest entailing a material risk of damage to the interests of one or more AIFs or its investors has arisen or, in the case of an ongoing activity, may arise.

16. According to Article 14(1) second subparagraph of the AIFM Directive AIFM shall disclose non systematic conflicts of interest to the AIF investors.

17. Furthermore, Article 14(2) of the AIFM-Directive requires that the AIFM shall clearly disclose the general nature or sources of conflicts of interest to the investors before undertaking business on their behalf where organisational arrangements made by the AIFM to identify, prevent, manage and monitor conflicts of interest are not sufficient to ensure, with reasonable confidence, that risks of damage to investors' interest will be prevented.

18. In addition, Box 71 requires that whenever the AIFM has delegated the portfolio management or risk management, it should also disclose conflicts of interest between the delegate or sub-delegate and the AIFM or the investors of the respective AIF.

19. With regard to the way of disclosure paragraph 2 requires that AIFM should disclose conflicts of interest to an investor either by a durable medium or – subject to the conditions of paragraph 3 – by means of a website.

Box 24

Strategies for the exercise of voting rights

1. AIFM should develop adequate and effective strategies for determining when and how any voting rights held in the managed portfolios are to be exercised, to the exclusive benefit of the AIF and its investors concerned.

2. The strategy referred to in paragraph 1 should determine measures and procedures for:

   (a) monitoring relevant corporate actions;

   (b) ensuring that the exercise of voting rights is in accordance with the investment objectives and policy of the relevant AIF;

   (c) preventing or managing any conflicts of interest arising from the exercise of voting rights.

3. A summary description of the strategies and details of the actions taken on the basis of those strategies shall be made available to the investors on their request.

Explanatory text

20. In line with the UCITS approach (Article 21 UCITS Level 2) AIFM should develop strategies for the exercise of voting rights. However, since the AIFM-Directive regulates the marketing to professional

investors unlike Article 21(3) UCITS Level 2, a summarized description of the strategies has to be made available to investors only on their request.

21. Although strategies for the exercise of voting rights should be developed, this does not exclude the possibility not to exercise voting rights if this is to the exclusive benefit of the AIF and its investors.

IV.IV. Possible Implementing Measures on Risk Management

1. In this section of the consultation EMSA responds to the Commission's request for advice in relation to Article 15 of the AIFMD, which relates to risk management. Specifically ESMA is seeking to achieve cross-sector consistency through the utilisation of relevant articles of Directive 2009/65/EC whilst considering the heterogeneous population of AIFs and AIFM.

2. Most of the respondents to the call for evidence who made specific suggestions or comments in relation to risk management suggested that ESMA should target an appropriate level of cross-sectoral consistency or suggested that MiFID and UCITS should be used as a benchmark for ESMA's advice in this regard. In addition, there was support for the view that ESMA should not seek to harmonise the technical detail of the systems that AIFMs use to manage risk and that a 'one size fits all' approach was not appropriate.

3. The following specific points were made by many respondents:

    - It would present significant challenges for private equity firms to separate the risk and portfolio management activities and, as such, ESMA should rather recognise the specificities of the AIFMs that mange private equity funds and tailor the advice accordingly;

    - ESMA should strongly consider the principle of proportionality in relation to the risks of the AIF/AIFM (see below), in addition in relation to the review of functional and hierarchal independence it may be more appropriate for local competent authorities to make the assessment on a case-by-case basis to reflect the specificities of local risks and the heterogeneous nature of AIFs/AIFMs.

4. ESMA recommends that AIFM set quantitative and/or qualitative limits for all relevant risks and have in place a documented policy for the management of those risks. The policy should contain details of the effective procedures and the appropriate systems and how these may be used to achieve the objective of ensuring that the risk profile of the AIF is aligned to the profile disclosed to investors in accordance with Article 23(4)(c) of the AIFMD. ESMA recommends that the risk management policy is kept up to date, which necessarily will involve periodic review.

5. To achieve a robust risk management framework, AIFM should establish a permanent risk management function whose role is to implement the policies, procedures or systems developed by the AIFM and regularly report to the governing body or where it exists the supervisory function on matters pertaining to the consistency with the limits that have been set for the AIFs that it manages, the adequacy of the procedures or systems in place and any current or anticipated breaches to this framework.

6. ESMA has provided advice in relation to the concept of 'functional and hierarchical separation' of the risk management function and the safeguards that may be required where this separation does not exist. This advice sets a strong framework for ensuring an appropriate degree of independence in relation to the risk management function which is sufficiently tailored for the heterogeneous population of AIFM.

7. ESMA has additionally provided a robust set of principles in relation to the due diligences AIFM should undertake prior to making investments on behalf of the AIF.

8. ESMA has decided that it would be inappropriate to provide advice as to which risks are more or less relevant for given strategies, in addition ESMA has not provided advice on the specific construction of the portfolio stress tests that AIFM may perform. ESMA considers it is more appropriate to focus on and to enhance the governance structures envisioned under the 2009/65/EC Directive to ensure that there are robust controls that ensure the risk profile disclosed to investors is aligned with the actual risk profile of the AIF.

Level 1 text[13] – Article 15

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

The functional and hierarchical separation of the functions of risk management in accordance with the first subparagraph shall be reviewed by the competent authorities of the home Member State of the AIFM in accordance with the principle of proportionality, on the understanding that the AIFM shall, 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.

2. AIFMs shall 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.

AIFMs shall review the risk management systems with appropriate frequency, at least once a year and adapt them whenever necessary.

3. AIFMs shall at least:

(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 with 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.

Scope of the Commission's implementing powers

5. The Commission shall adopt by means of delegated acts, in accordance with Article 56, and subject to the conditions laid down in Articles 57 and 58, measures specifying:

(a) the risk management systems to be employed by AIFM in relation to the risks which they incur on behalf of the AIF that they manage;

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

(c) how the risk management function is to 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 second subparagraph of paragraph 1;

(e) the requirements referred to in paragraph 3.

[13] 'Level 1' was part of the terminology used under the Lamfalussy procedure for European financial regulation and referred to the Directive or Regulation setting out framework principles, to be complemented by detailed implementing measures at Level 2.

European Commission's Request for Advice to ESMA (CESR)

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

   In particular, CESR is requested:

   a) to advise on the categories of risk relevant to each AIF investment strategy and to which each AIF is or can be exposed and the methods for identifying the risks that are relevant for the particular AIF investment strategy or strategies so that all risks are adequately identified;

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

   c) to advise on adequate methods for managing and monitoring all such risks so that the AIF risk exposures respect at all times the risk objectives of the AIF.

2. CESR is requested to advise the Commission on the appropriate frequency of review of the risk management system. CESR is invited to consider whether the appropriate frequency of review varies according to the type of AIFM or the investment strategy of the AIF

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

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

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

5. CESR is requested to advise the Commission on the content of the requirements referred to in Article 15(3).

6. This advice should at least address the following issues:

   a) the content of 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) the criteria to be used by competent authorities when assessing whether the risks associated with 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 stress testing;
c) appropriate stress testing procedures and their frequency pursuant to Article 15(3)(b);
d) the criteria to be used in assessing whether the risk profile of the AIF corresponds 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.

'UCITS' risk management activities

9. This section proposes how those elements of the risk management provisions in Articles 12, 23 and 38-43 of the UCITS Implementing Directive could be applied to the AIFMD.

Proposed Advice

Box 25

Permanent Risk Management Function

1. The AIFM shall establish and maintain a permanent risk management function that shall:

(a) implement effective risk management policies and procedures in order to identify, measure, manage and monitor on an ongoing basis all risks relevant to each AIF's investment strategy, to which each AIF is or may reasonably be exposed;

(b) ensure that the risk profile of the AIF disclosed to investors in accordance with Article 23(4)c of Directive 2011/61/EU, is consistent with the risk limits that have been set in accordance with Box 29;

(c) monitor compliance with the risk limits set in accordance with Box 29 and notify the AIFM's governing body and where it exists the AIFM's supervisory function in a timely manner when it considers the AIF's risk profile is inconsistent with these limits or where it is aware there is a material risk that it will be inconsistent with these limits;

(d) provide the following regular updates to the governing body of the AIFM and where it exists the AIFM's supervisory function at a frequency which is in accordance with the nature, scale and complexity of the AIF and/or the AIFM's activities:

(i) the consistency between and the compliance with, the risk limits set out in [Box 29, Risk Limits] and the risk profile of that AIF as disclosed to investors in accordance with Article 23(4)(c) of Directive 2011/61/EU; and
(ii) the adequacy and effectiveness of the risk management process, indicating in particular whether appropriate remedial measures have or will be taken in the event of any actual or anticipated deficiencies; and

(e) provide regular updates to the senior management outlining the current level of risk incurred by each managed AIF and any actual or foreseeable breaches to any risk limits set out in Box 29, so as to ensure that prompt and appropriate action can be taken.

2. The AIFM shall ensure that the permanent risk management function shall have the necessary authority and access to all relevant information necessary to fulfil the tasks set out in paragraph 1.

Explanatory Text

10. ESMA's advice on the role of the permanent risk management function is based on Article 12 of the UCITS implementing directive (2010/43/EU) and revisions have been made to this article to bring it into line with the terminology of the AIFMD and to make it relevant to the many types of AIFM/AIF that will fall under its scope. Specifically this advice explains the tasks that should be undertaken by the permanent risk management function and that the function must have the necessary authority and access to information to fulfil those tasks.

- The policies and procedures implemented by the risk management function must be effective so that it can identify, measure, manage and monitor on an ongoing basis all risks relevant to each AIF's investment strategy, to which each AIF is or may reasonably be exposed. ESMA does not consider that it is appropriate to advise the Commission which risks will be more or less relevant to specific strategies and in general many if not all risks will be relevant.

- This advice does not remove the responsibility of the governing body or senior management of the AIFM to set risks limits for the AIF, however ESMA considers that it is the responsibility of the permanent risk management function to ensure that those limits are in line with the risk profile disclosed to investors in accordance with Article 23(4)c of Directive 2011/61/EU. ESMA recommends that setting risk limits in line with the strategy of the AIF is a framework that should be applied across all types of AIFM.

- ESMA considers that once a risk framework has been constructed through the use of quantitative and/or qualitative limits the role of the permanent risk management function is to monitor compliance with those limits and notify the governing body and, where it exists, the AIFM's supervisory function in a timely manner when it considers that there has been a breach. The form of notification is likely to vary according to the nature of the inconsistency.

- ESMA considers that the governing body of the AIFM should regularly receive certain pieces of information from the permanent risk management function:

    - The risk management function should provide information in relation to the consistency between the risk framework and the current risk profile of the AIF. This information may be useful for the governing body of the AIFM to identify when the AIF is close to breaching a particular limit, or how often it has breached limits in the past.

    - The governing body should also know if the risk management procedures that have been put in place are effective and if they have been demonstrated not to be effective what measures have been taken to rectify the situation. In order for the risk management function to provide useful information in this regard it may be necessary to review the systems in place on a periodic basis.

- The risk management function should be proactive and outline any actual or foreseeable breaches to senior management. A necessary component of this may be portfolio stress tests to identity scenarios that would lead to breaches in limits.

11. The governing body of an AIFM refers to the component of the governance structure with ultimate jurisdiction and power of direction. In corporate structures this is usually the board of directors but in

other structures may be an equivalent body. The governing body is distinct from senior management, who it directs, but some or all members of senior management may comprise the governing body which may also contain non-executive members.

Proposed Advice

Box 26

Risk Management Policy

1. AIFM shall establish, implement and maintain an adequate and documented risk management policy which identifies all the relevant risks to which the AIF they manage are or might be exposed to.

2. The risk management policy shall comprise such procedures as are necessary to enable the AIFM to assess for each AIF it manages the exposure of that AIF to market, liquidity and counterparty risks, and the exposure of the AIF to all other relevant risks, including operational risks, which may be material for each AIF it manages.

3. AIFM shall address at least the following elements in the risk management policy:

   (a) the techniques, tools and arrangements that enable them to comply with the obligations set out in Box 28;
   (b) the techniques, tools and arrangements that enable the assessment and monitoring of the liquidity risk of the AIF, under normal and exceptional liquidity conditions including through the use of regularly conducted stress tests in accordance with Box 33;
   (c) the allocation of responsibilities within the AIFM pertaining to risk management;
   (d) the limits set in accordance with Box 29 and a justification of how these are aligned with the risk profile of the AIF disclosed to investors in accordance with Article 23(4)(c) of Directive 2011/61/EU; and
   (e) where the risk management function is not functionally or hierarchically separate the AIFM shall include a description of the safeguards referred to in Box 30 that allow for an independent performance of the risk management function. This description shall include:

      (i) the nature of the conflict of interest;
      (ii) the remedial measures put in place;
      (iii) the reasons why this measure should be reasonably expected to result in an independent performance of the risk management function; and
      (iv) how the AIFM expects to ensure that the safeguards are consistently effective.

4. AIFM shall ensure that the risk management policy referred to in paragraph 1, 2 and 3 states the terms, contents and frequency of reporting of the risk management function referred to in Box 25 to those charged with governance, to senior management and, where it is appropriate, the supervisory function.

5. For the purposes of paragraphs 1-4, AIFM shall take into account the nature, scale and complexity of their business and of the AIF it manages.

Explanatory Text

12. ESMA's advice is based on Article 38 of 2010/43/EU and requires the AIFM to have a documented risk management policy that at least contains the following information:

- a justification of the risk limits set in accordance with Box 29;
- details of the allocation of responsibilities within the AIFM relating to risk management;
- the techniques used to manage risk, including liquidity risk;
- an explanation of the safeguards for an independent performance of the risk management function in accordance with Box 30;
- an explanation of the policy and procedures employed in accordance with Box 28; and
- an explanation of the frequency of reporting to those charged with governance in accordance with Box 25.

13. This advice should apply to all type of AIFM however ESMA recommends that AIFM take into account the nature scale and complexity of their business and of the AIF it manages when setting the risk management policy.

14. The risk management policy should take the form of a separate document. Where it is not proportionate to have a separate risk management policy, it can also be documented within the existing organisational and procedural rules of the AIFM, provided that the different documents allow for a clear identification of risk management roles, responsibilities and operating procedures.

Proposed Advice

Box 27

Assessment, monitoring and review of the risk management policy

1. AIFM shall assess, monitor and periodically review:

   (a) the adequacy and effectiveness of the risk management policy and of the arrangements, processes and techniques referred to in Box 28;

   (b) the level of compliance by the AIFM with the risk management policy and with the arrangements, processes and techniques referred to in Box 28;

   (c) the adequacy and effectiveness of measures taken to address any deficiencies in the performance of the risk management process; and

   (d) the measures set out in the risk management policy to ensure the functional and hierarchical separation of the risk management function in accordance with Box 30.

2. AIFM shall notify the competent authorities of their home Member State of any material changes to the risk management policy and of the arrangements, processes and techniques referred to in Box 28.

3. AIFM shall ensure that the periodic review in accordance with paragraph 1 is carried out:

   (a) at a set frequency which is in accordance with the principle of proportionality including its appropriateness given the nature, scale and complexity of their business and the AIF it manages, that frequency being at least annual;
   (b) when material changes are made to the risk management policy and of the arrangements, processes and techniques referred to in Box 28;
   (c) when internal or external events indicate that an additional review is required; and
   (d) when material changes are made to the investment strategy and objectives of an AIF the AIFM manages.

Explanatory Text

15. ESMA's advice is based on Article 39 of 2010/43/EU and explains the frequency and content of the review that needs to be performed. The key elements that need to be reviewed are:

- the accuracy, effectiveness and the compliance with the policy and procedures for risk management;
- the adequacy of remedial measures taken when there have been problems with the accuracy, effectiveness or compliance with the policy and procedures for risk management; and
- the effectiveness of the safeguards to ensure an independence performance of the risk management function.

16. The frequency of review of the above elements must at least be annual but should be made when there is a risk that it may no longer be adequate. ESMA has included within this advice a list of situations where there is a risk that the policy and procedures may no longer be adequate.

17. AIFM should notify the competent authority when there is a material change to the risk management policy and of arrangements, processes and techniques used to manage risk.

18. The senior management of the AIFM should be responsible for, and be actively involved in the control of the adequacy and effectiveness of the risk management process and should regard this as an essential aspect of the business to which adequate resources need to be devoted. In particular, senior management should approve the risk management policy, the risk profile and risk limit system for each AIF managed. It should ensure that all aspects of the risk management process, including the risk management function itself, are subject to appropriate review. It should take appropriate action in the best interest of investors in the cases of evidence that the actual level of risk incurred by the AIF is not consistent with its target risk profile.

Proposed Advice

Box 28

Measurement and Management of Risk

1. AIFM shall adopt adequate and effective arrangements, processes and techniques in order to:

   (a) identify, measure, manage and monitor at any time the risks to which the AIF under their management are or might be exposed to including those sources of risk the AIFM incurs on behalf of the AIF; and

   (b) ensure compliance with the limits set in accordance with Box 29.

2. Those arrangements, processes and techniques referred to in paragraph 1 shall be proportionate to the nature, scale and complexity of the business of the AIFM and of the AIF they manage and shall be consistent with the AIF risk profile as disclosed to investors in accordance with Article 23(4)(c) of Directive 2011/61/EU.

3. For the purposes of paragraph 1, AIFM shall take the following actions for each AIF they manage:

   (a) put in place such risk measurement arrangements, processes and techniques as are necessary to ensure that the risks of positions taken and their contribution to the overall risk

profile are accurately measured on the basis of sound and reliable data and that the risk measurement arrangements, processes and techniques are adequately documented;

(b) conduct periodic back-tests in order to review the validity of risk measurement arrangements which include model-based forecasts and estimates;

(c) conduct periodic stress tests and scenario analyses, on the basis of reliable and up-to-date information, both in quantitative and qualitative terms to address risks arising from potential changes in market conditions that might adversely impact the AIF;

(d) ensure that the current level of risk complies with the risk limit policy and procedures as set out in accordance with Box 29;

(e) establish, implement and maintain adequate procedures that, in the event of actual or anticipated breaches of the risk limit policy and procedures of the AIF, result in timely remedial actions in the best interests of investors; and

(f) ensure that there are appropriate liquidity management processes for each AIF in line with the requirements set out in Box 32.

Explanatory Text

19. This box sets out the criteria for the policy and procedures and processes that the AIFM will be required to implement to identify, monitor and manage risk.

20. The requirements in paragraph 1(a) acknowledge that certain activities undertaken by the AIFM on behalf of the AIF may expose the AIF to additional risks. The requirements are based on Article 40 of Directive 2009/65/EC (UCITS IV), thereby building on the standards which apply to UCITS management companies and ensuring consistency.

21. AIFM should employ proportionate and effective risk measurement techniques, which include both quantitative measures, as regards quantifiable risks, and qualitative methods. IT systems and tools used for the computation of quantitative measures should be integrated with one another or with the front-office and accounting applications. Risk measurement techniques should allow for an adequate measurement of risks in periods of increased market turbulence and be reviewed whenever necessary in the interest of investors.

22. AIFM should deal appropriately with the possible vulnerability of their risk measurement techniques and models by carrying out stress tests, back tests and scenario analyses. Where stress tests and scenario analyses reveal particular vulnerability to a given set of circumstances, prompt steps and corrective actions shall be taken to manage those risks appropriately.

23. It is important that AIFM have systems in place which result in relevant risks being monitored and managed effectively for the benefit of investors. Risk management methodologies are generally proprietary and contribute significantly to the performance of AIF.

24. ESMA considers that AIFM should in general ensure that the governance arrangements pertaining to risk management are sufficiently robust. Specifically ESMA would like to highlight that within an overall governance structure there will be a broad range of systems employed to facilitate the risk management process and different methodologies to manage risk may be applicable in different situations. ESMA does not consider it appropriate to provide advice on the types of risk management methodolo-

gies that AIFM should employ. ESMA has however provided advice which seeks to achieve the outcome that all AIFM will have in place adequate procedures for the monitoring of risk both from a systems and governance perspective. This can then be assessed by competent authorities upon authorisation.

Proposed Advice

Box 29

Risk Limits

1. AIFM shall establish and implement quantitative and/or qualitative risk limits for each AIF they manage, taking into account all relevant risks. Where only qualitative limits are set the AIFM shall be able to justify this approach to the relevant competent authority.

2. The qualitative and quantitative risk limits for each AIF shall, at least, cover the following risks:

   (a) market risks;
   (b) credit risks;
   (c) liquidity risks;
   (d) counterparty risks; and
   (e) operational risks.

When setting risk limits AIFM shall take into account the strategies and assets employed in respect of each AIF it manages as well as the national rules applicable to each of those AIF. These risk limits should be aligned with the risk profile of the AIF as disclosed to investors in accordance with Article 23(4)(c) of Directive 2011/61/EU and approved by the governing body.

Explanatory Text

25. The risks applicable to each AIF and the specific methods used by AIFM to assess those risks will vary from case to case but broadly they fall into operational and financial risks categories. It is important to note that CESR stopped short of providing a full indicative list in its Risk management principles for UCITS (Ref. CESR/09-178)[14] but did include reference to all those risks listed above which are also applicable to AIF.

26. By managing operational risks the AIFM establishes a platform from which it can effectively run its investment strategy; however, there are cases where a failure in operations can impact the return of the AIF. ESMA would like to note the operational risk discussion in the aforementioned Risk management principles for UCITS and specifically make reference to a few key instances of operational risk:

- failure of the information technology that directly or indirectly connects the AIFM to the market;
- risk of key persons leaving the firm;
- failure in the investment reconciliation process performed by fund administrators;
- fraud; and

[14] http://www.esma.europa.eu/popup2.php?id=5620

- failure in trading, settlement and valuation services.

27. AIFM shall establish and implement quantitative and/or qualitative risk limits for each AIF they manage, taking into account all relevant risks. Investment risks will depend on the risk profile of the AIF and the AIFM should seek to manage market, credit, liquidity, counterparty and operational risks.

28. ESMA considers that in the majority of cases quantitative risk limits can be set by AIFM, therefore where the AIFM does not set quantitative limits they should be able to justify this to the competent authority.

29. The AIFMD does not impose any investment restrictions on AIF. However ESMA considers that a precondition for effective risk management is a framework of risk limits. ESMA does not consider that it is appropriate to advise the Commission on which risks will be more or less relevant to specific strategies. The only limitation placed on AIFM with regard to risk is that they manage the AIF in line with the risk profile disclosed to investors in accordance with Article 23(4)(c) of Directive 2011/61/EU

30. Market risk is typically referred to as the liability to fluctuations in the market value of the positions entered into by the AIF, which may vary over time. ESMA would specifically like to highlight the position put forward by CESR within its Risk management principles paper which states that 'market risk can still be thought of as capturing the exposure to standard movements in micro-economic and/or macro-economic variables (sales, profits, equity premia, interest rates, exchange rates). However, the other risk factors, namely credit, counterparty and liquidity risk, are often interpreted as representing the possible impact of events which may impair the trading conditions of certain securities (illiquidity) or the credit rating of specific issuers (default) or counterparties of bilateral transactions (insolvency). Specific risks, such as credit or liquidity risk, may also refer to the exposure to sudden sharp changes in the macroeconomic environment (such as a widening of risk premia – a 'flight to quality' – or a downgrading of a specific sector or sovereign exposures).'

Proposed Advice

Box 30

Functional and Hierarchical Separation of the Risk Management Function

1. The risk management function of an AIFM may be said to be functionally and hierarchically separate from the operating units, including the portfolio management function, where all the following conditions are satisfied:

   (a) Those engaged in the performance of the risk management function are not supervised by those responsible for the performance of the operating units, including the portfolio management function, of the AIFM;
   (b) Those engaged in the performance of the risk management function are not engaged in the performance of activities within the operating units, including the portfolio management function;
   (c) Those engaged in the performance of the risk function are compensated in accordance with the achievement of the objectives linked to that function, independent of the performance of the other conflicting business areas;
   (d) The remuneration of the senior officers in the risk management functions is directly overseen by the remuneration committee, where the AIFM is sufficiently significant in terms of its size or the size of the AIF it manages, its internal organisation and the nature, the scope and the complexity of its activities to have established such a committee; and

(e) The separation is ensured up to the governing body of the AIFM.

2. The functional and hierarchical separation of the functions of risk management in accordance with paragraph 1 shall 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 shall in any event be able to demonstrate that specific safeguards against conflicts of interest allow for the independent performance of risk management activities.

3. The governing body of the AIFM, and where it exists the supervisory function, shall review the risk management function in accordance with paragraph 1. Where compliance cannot be achieved the governing body of the AIFM, and where it exists the supervisory function, shall identify material conflicts of interest that may pose a risk to the independent performance of risk management activities and shall ensure that procedures are in place which may reasonably be expected to result in an independent performance of the risk management function. These safeguards shall be documented in the risk management policy and must include (a), (b), (C) and (e) and may also include (d) and (f) where this is proportionate taking into account the nature, scale and complexity of the AIFM:

   (a) procedures to ensure that the data used by the risk management function in making decisions is reliable and subject to an appropriate degree of control by the risk management function so as to allow for the independent performance of its duties;
   (b) that staff members engaged in risk management are compensated in accordance with the achievement of the objectives linked to the risk management function, independent of the performance of the business areas in which they are engaged;
   (c) that key risk management function is subject to an appropriate independent review to ensure that decisions are being arrived at independently;
   (d) that there is a review of the risk management function by an independent external party or, where applicable the internal audit function;
   (e) segregation of conflicting duties; and
   (f) an appropriately resourced risk committee that reports directly to the AIFM's governing body where the non-independent members of such a committee do not have undue influence over the process.

4. The safeguards referred to in paragraph 3 must be subject to regular review by the governing body of the AIFM, and where it exists the supervisory function, which shall require timely remedial action to be taken to address deficiencies.

Explanatory Text

31. ESMA is required to provide advice to the Commission regarding '*how the risk management function shall be functionally and hierarchically separated from the operating units, including the portfolio management function*'.

32. Paragraph 1 explains what arrangements may be considered as functionally and hierarchically separate. Essentially it provides that those in the risk management function should not be supervised by someone who is in charge of conflicting functions; neither should they be undertaking conflicting tasks themselves. Point (e) of the first paragraph clarifies that this separation must be up to the AIFM's governing body because if not then it is likely there would be an individual who is supervising the risk management function in addition to other conflicting tasks.

33. Level 1 recognised that the risk management function may not be 'functionally and hierarchically separated' but shall still result in the independence performance of its activities after applying certain safeguards. The safeguards required have been set out above in paragraph 3 whilst requiring review at an appropriate interval in paragraph 4.

34. A key safeguard is that the risk management function does not itself determine if it is functionally and hieratically separated, but rather the AIFM's governing body make this determination, assess the risks and set the appropriate mitigating procedures.

35. The competent authority is charged with reviewing the functional and hieratical separation of the risk management function in line with the principle of proportionality and after considering the safeguards employed by the AIFM. The criteria that competent authorities may use when making this assessment could include:

- The operational structure of the AIFM/AIF and the risks to independence that result from the risk management function not being functional and hierarchically separated in accordance with ESMA's advice above;
- The corporate governance arrangements at the AIFM/AIF;
- The marginal benefits vs. the costs to investors for implementing the safeguards;
- The extent to which the risk management function is inseparable from the portfolio management function;
- The levels of staff competent within the organisation and the general control environment; and
- The expectations of professional investors as to the benefits of changes to the risk management function.

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

Q19: ESMA would like to know which types of AIFM will have most difficultly in demonstrating that they have an independent risk management function? Specifically what additional proportionality criteria should be included when competent authorities are making their assessment of functional and hierarchal independence in accordance with the proposed advice and in consideration of the safeguards listed?

IV.V. Possible Implementing Measures on Liquidity Management

1. The illiquidity of major financial markets during the financial crisis placed considerable strain on the liquidity of many types of AIFs and therefore on their ability to meet redemption requests. As a result the AIFMD provides that AIFM must implement, for each AIF under its management, excluding unleveraged closed-ended AIF, appropriate liquidity management systems and procedures to ensure that the liquidity profile of the investments of the AIF is consistent with the underlying obligations towards investors.

2. Various initiatives are being undertaken in international fora on the liquidity management of collective investment schemes (CIS) including by IOSCO. Furthermore, guidance has been produced by various industry representatives including AIMA, HFSB, MFA and the Asset Managers' Committee of the US PwG. The work being undertaken in international fora has been utilised by ESMA to assist in the development of its proposed advice.

3. The heterogeneous and diverse nature of the population of AIF within the scope of the Directive presents significant challenges to specify the detailed mechanics or procedures for the management of liquidity. ESMA therefore proposes to set fundamental general requirements to all AIFM which can be adapted to the diverse size and structure of the AIFM and to the nature of the AIF under management.

4. ESMA considers that the primary role of the liquidity management framework is to limit the risk that the liquidity profile of the AIF's investments does not align with its underlying obligations. ESMA believes that such an approach is consistent with the request from the Commission to specify rules that are proportionate and necessary for specifying the general obligations placed on AIFM by Article 16(1) and (2) of the AIFM Directive.

5. Respondents to the call for evidence suggested that ESMA should not seek to harmonise the technical detail of the systems that AIFM use to manage liquidity risk and that a 'one-size-fits-all' approach was not appropriate. There were also calls for flexibility regarding redemption policies. Specifically, respondents highlighted that the potential need to have recourse to redemption or issuance gates or side pocketing should be considered at launch, especially where open-ended AIFs are likely to invest in hard-to-value or less liquid assets as part of their objectives. Respondents supported the view that the most basic principle regarding liquidity management is to ensure at all times a realistic matching between the redemption terms of the AIF and the liquidity of its underlying assets.

6. A number of respondents were concerned by the reference in the Call for Evidence to the use of UCITS as a benchmark as they believed this was not an appropriate framework for AIFs.

7. Some respondents cautioned that it would not be in the interests of investors, wishing to access illiquid investments, to restrict the AIF's ability to invest because of liquidity requirements which do not take in to account the AIF's ability to defer redemptions.

Extract from Level 1 Directive (Article 16)

1. *AIFMs shall, for each AIF they manage, which is not an unleveraged closed-ended AIF, employ an appropriate liquidity management system and adopt procedures which enable them 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.

AIFMs shall regularly conduct stress tests, under normal and exceptional liquidity conditions, which enable them to assess the liquidity risk of the AIFs and monitor the liquidity risk of the AIFs accordingly.

2. *AIFMs shall ensure that, for each AIF that they manage the investment strategy, the liquidity profile and the redemption policy are consistent.*

Scope of the Commission's implementing powers

The Commission shall adopt by means of delegated acts in accordance with Article 56, and subject to the conditions laid down in Articles 57 and 58, measures specifying:

(a) the liquidity management systems and procedures; and
(b) the alignment of the investment strategy, liquidity profile and redemption policy set out in paragraph 2.

European Commission's Request for Advice to ESMA (CESR)

1. CESR is invited to advise the Commission on the content of rules that are proportionate and necessary for specifying the general obligations placed on AIFM by Article 16(1) and (2).

2. In particular, CESR is invited to advise on:

   a) the systems and procedures to be implemented by the AIFM in order to comply with its obligations under Article 16(1), having regard for the appropriateness of these systems and procedures for different types of AIFM and the AIF they manage;

   b) the content of the obligation for AIFM 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;

   c) the circumstances under which the investment strategy, liquidity profile and redemption policy for each AIF managed by an AIFM can be considered to be consistent. In this context, CESR is invited to consider all relevant aspects of the redemption policy, including mechanisms that can be invoked in exceptional circumstances, and assess their consistency with the investment strategy and liquidity profile.

Proposed Advice

Box 31

Liquidity Management Definitions

'Special arrangement' means an arrangement that arises as a direct consequence of the illiquid nature of the assets of an AIF which impact the specific redemption rights of investors in a class of units or shares of the AIF and which is a bespoke or separate arrangement from the general redemption rights of investors.

Explanatory Text

8. Article 23(4)(a) of the Directive requires that AIFMs shall, for each of the EU AIFs they manage and for each of the AIFs that they market in the Union, periodically disclose to investors '*the percentage of the AIF's assets which are subject to special arrangements arising from their illiquid nature*'. ESMA con-

siders that as the Directive imposes an obligation on AIFM to disclose the percentage of the AIF's assets which are subject to special arrangements, the Directive envisages that part of the AIF's assets could be subject to these arrangements.

9. ESMA is of the opinion that a special arrangement is one type of tool or arrangement for managing liquidity. ESMA has proposed to define special arrangements with reference to the relevant provision in the Directive which states special arrangements arise from the illiquid nature of an AIF's assets. ESMA intends this definition to include 'side pockets' and other mechanisms where certain assets of the AIF are subject to similar arrangements between the AIF and its investors. ESMA believes that the suspension of an AIF should not be considered to be a special arrangement as this does not constitute a separate or bespoke arrangements but rather an 'arrangement' which applies to all of the AIF's assets and all of the AIF's investors. Other 'arrangements' such as gates should be considered as special arrangements where they achieve similar outcomes to those achieved by side pockets.

Proposed Advice

Box 32

Liquidity Management Policies and Procedures

1. AIFMs shall, for each AIF that they manage that is not an unleveraged closed-ended AIF, adopt appropriate liquidity management policies and procedures enabling them to monitor the liquidity risk of each AIF and comply with their underlying obligations to investors, counterparties, creditors and other parties. AIFMs for each AIF that they manage that is a leveraged closed-ended AIF, shall not be required to comply with paragraphs 3(c), 3(f) to 3(g) and Paragraph 1 of Box 33.

2. In order to comply with their obligations under paragraph 1, AIFMs shall be able to demonstrate to the competent authorities of its home Member State that appropriate and effective liquidity management policies and procedures are in place taking into account the investment strategy, the liquidity profile and the redemption policy of each AIF.

3. Having regard to the alignment of the investment strategy, liquidity profile and redemption policy, AIFMs shall, for each AIF they manage, implement the following policies and procedures in order to comply with their obligations under Article 16 (1) of Directive 2011/61/EU:

   (a) AIFMs shall maintain a level of liquidity in the AIF appropriate to its underlying obligations, based on an assessment of the relative liquidity of the AIF's assets in the market, taking account of the time required for liquidation and the price or value at which those assets can be liquidated, and their sensitivity to other market risks or factors;

   (b) AIFMs shall monitor the liquidity profile of the portfolio of the AIF's assets, having regard to the marginal contribution of individual assets which may have a material impact on liquidity, and the material liabilities and commitments (contingent or otherwise) which the AIF may have in relation to its underlying obligations. For these purposes AIFMs shall take in to account the profile of their investor base including the type of investors in the AIF, the relative size of investments and the redemption terms to which these investments are subject;

   (c) AIFMs shall, where the AIF invests in other collective investment undertakings, monitor the approach adopted by the managers of those other collective investment undertakings to the management of liquidity, including through conducting periodic reviews, to monitor changes to the redemption provisions of the underlying collective investment undertakings in which the AIF invests. Notwithstanding the requirements of paragraph 1, this provision shall not apply where the

other collective investment undertaking in which the AIF invests is actively traded on a regulated market within the meaning of Article 4 (1) (14) of Directive 2004/39/EC or an equivalent third country market;

(d) AIFMs shall implement and maintain appropriate liquidity measurement arrangements and procedures to assess the quantitative and qualitative risks of positions and of intended investments which have a material impact on the liquidity profile of the portfolio of the AIF's assets to enable their effects on the overall liquidity profile to be appropriately measured. The procedures employed shall ensure that AIFMs have the appropriate knowledge and understanding of the liquidity of the assets in which the AIF has invested or intends to invest including, where applicable, the trading volume and sensitivity of prices and/or spreads of individual assets in normal and exceptional liquidity conditions;

(e) In accordance with the requirements of Article 23 (1) (h) of Directive 2011/61/EU AIFMs shall implement appropriate policies and procedures to ensure that the redemption policies of the AIF are disclosed to investors, in sufficient detail and with sufficient prominence, before they invest in the AIF and in the event of material changes;

(f) AIFMs shall consider and put in to effect the tools and arrangements necessary to manage the liquidity risk of each AIF under its management. AIFMs shall identify the types of circumstances where tools and arrangements will be used in both normal and exceptional circumstances, taking into account the fair treatment of all AIF investors, in relation to each AIF under management. AIFMs may only use such tools and arrangements in these circumstances and if appropriate disclosures have been made in accordance with point (e);

(g) AIFMs shall identify, manage and monitor conflicts of interest arising between investors wishing to redeem their investment(s) and those investors wishing to maintain their investment(s) in the portfolio, and any conflicts between the AIFMs incentive to invest in illiquid assets and the AIF's redemption policy in accordance with their obligations under Article 14 (1) of Directive 2011/61/EU;

(h) AIFMs shall document their liquidity management policies and procedures, review these on at least an annual basis and update these for any changes or new arrangements; and

(i) AIFMs shall include appropriate escalation measures in their liquidity management policies and procedures to address anticipated or actual liquidity shortages, or other distressed situations of the AIF.

Explanatory Text

10. The heterogeneous and diverse nature of the population of AIFs within the scope of the Directive presents significant challenges to specifying the detailed mechanics or procedures for the management of liquidity. ESMA therefore proposes to set fundamental general requirements for all AIFMs which can be adapted to the diverse size and structure of the AIFM and to the nature of the AIF under management.

11. ESMA considers that the primary role of the liquidity management framework which AIFMs should develop should be to limit the risk that the liquidity profile of the AIF's investments is not aligned with its underlying obligations to investors, counterparties, creditors and other third parties.

12. These general requirements should be capable of calibration in an appropriate and proportionate manner which duly reflects the specific characteristics of the AIF including legal structure and national legislation.

13. The requirement to monitor the management of liquidity of underlying collective investment undertakings in which AIFs invest as set out in paragraph 3(c), along with the requirements to put in place tools and arrangements to manage liquidity risk and identify, manage and monitor conflicts of interest between investors as set out in paragraph 3(f) and 3(g) respectively are not applied to AIFMs managing AIFs of the closed-ended type regardless of whether they are deemed to be employing leverage. The exemption of these 'redemption' related liquidity management requirements reflects the differences in the general redemption terms of investors of a closed-ended AIF compared to those in an open-ended AIF. Furthermore, the requirements in paragraph 1 of Box 32 are also not applied to AIFM managing AIF of the closed-ended type.

14. The principle of proportionality should be applied in application of the requirements to the nature (e.g. taking in to consideration the underlying type of assets and the amount of liquidity risk to which the AIF is exposed), scale (e.g. where the AIF could move the market in respect of a significant position in an underlying asset) and complexity of the AIF (e.g. complexity of the process to liquidate or sell assets). However, AIFMs must be able to demonstrate to their competent authorities that appropriate and effective liquidity management policies and procedures are in place.

15. Paragraph 3 sets out the systems and procedures to be implemented by the AIFM in order to comply with its obligations under Article 16(1). In particular, AIFMs are required to implement policies and procedures, for each AIF under their management, to maintain a level of liquidity which is appropriate to their underlying obligations. Whilst ESMA does not wish to detract in any way from this overarching obligation on AIFM, ESMA recognises that there could be occasions where the AIFM is temporarily unable to maintain such level of liquidity, including as a result of unforeseen circumstances outside the AIFM's control. However, in accordance with the requirements in the Directive the AIFM must always endeavour to maintain this requirement and, where necessary, implement contingency plans in a timely manner. AIFMs are required to consider not only their obligations to investors, but also their obligations to counterparties, creditors and other third parties. This would mean that, for example, the AIFM of a leveraged closed-ended AIF would be required to maintain an appropriate level of liquidity to be able to service the debt in respect of any borrowings.

16. In order to achieve the above objective AIFMs are required to monitor the liquidity profile of the portfolio of the AIF's assets taking into account the marginal contribution of individual assets which may have a material impact on the liquidity profile and the profile of their investor base.

17. To enable AIFMs to monitor the liquidity profile of their managed AIFs they must implement and maintain appropriate liquidity measurement arrangements to assess the quantitative and qualitative risks of existing and intended investments which have a material impact on the liquidity profile of the AIF's assets. AIFM's should consider the liquidity of the types of instruments it intends to purchase or to which it could be exposed before entering into a transaction which could have a material impact on the overall AIF liquidity.

18. ESMA is of the opinion that disclosure to investors is of paramount importance and as a result has determined that AIFMs should implement appropriate policies and procedures to ensure that the redemption terms applicable to a particular AIF are disclosed in sufficient detail and with sufficient prominence to investors before they invest and in the event of material changes. This could include disclosure of notice periods in relation to redemptions, details of lock-up periods, an indication of circumstances in which normal redemption mechanics might not apply or may be suspended, together with

details of any measures which may be considered by the governing body such as gates, side pocketing, lock ups or penalties.

19. AIFMs which manage AIFs which are not closed-ended (whether leveraged or not) are required to consider and put into effect any necessary tools and arrangements to manage such liquidity risks. There are two key components to the management of liquidity risk: on the one hand management of asset liquidity, in particular illiquid assets and related valuation problems; and on the other hand management of redemption requests. Specific tools and arrangements have not been set out in this advice but it is envisaged that AIFMs should consider and put into effect the tools and arrangements (including 'special arrangements') necessary to manage the liquidity risk of each AIF under its management. Such tools and arrangements may include, where allowed under national law, gates, partial redemptions, temporary borrowings, side pockets, notice periods (i.e. 'cut-off' dates ahead of 'dealing' points), pools of liquid assets and suspensions. The reference to tools and arrangements allowed under national law and regulation in paragraph 3 (f) is also intended to capture requirements where imposed on authorisation. Consistent with the proposals in the recent consultation issued by IOSCO on 'Principles on Suspension of Redemptions in Collective Investment Schemes'[15], ESMA has not attempted to determine in what circumstances the different tools would be used or what constitutes normal and exceptional liquidity conditions. ESMA considers that the use of tools to manage liquidity will vary according to the nature, scale and investment strategy of the AIF and, as IOSCO has identified, any such determination would inevitably become out of date, or exclude circumstances which might be considered exceptional in the future.

20. IOSCO'S recent consultation provides a non-exhaustive list of what could constitute exceptional circumstances and includes: market failures, exchange closures, unpredictable operational problems and technical failures and unforeseeable liquidity issues. The IOSCO consultation paper also makes it clear that depending on the jurisdiction authorising them, gates may either cover extreme cases, or to the contrary, cover common redemptions where specific types of AIFM use these mechanisms as part of their regular liquidity management.

21. ESMA agrees with the view expressed by IOSCO in its recent consultation and arising from the report produced by IOSCO on suspending redemptions, that 'generally, suspensions may be justified only in exceptional circumstances' and ESMA also believes that the decision to suspend an AIF must be in the best interests of all AIF investors. IOSCO's recent consultation contrasts the use of suspensions with alternative measures to deal with the illiquidity of certain assets held by an investment fund. The creation of side pockets for illiquid assets held in an AIF portfolio may deal with episode of illiquidity or valuation problems for a specific amount of assets in the AIF.

22. ESMA believes that in any event, the policy and procedures of AIFM must identify what is meant by the alignment of the investment strategy, the liquidity profile and the redemption policy. This provision is not relevant to leveraged closed-ended AIF because such AIFs do not generally allow redemptions on the same terms as open-ended AIF.

23. ESMA's advice in relation to the use of tools and arrangements in both normal and exceptional circumstances combines a principles based approach with disclosure. The overarching requirement is that the fair treatment of investors must be taken in to account.

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[15] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD349.pdf

24. AIFMs which manage AIFs which are not closed-ended are also required to identify, manage and monitor conflicts of interest arising between investors wishing to redeem their investments and those investors wishing to maintain their investments in the portfolio and, where appropriate considering the nature, scale and complexity of the AIF, implement and maintain adequate limits on liquidity consistent with the redemption policy of the AIF.

25. AIFMs are required to document their liquidity management policies and procedures and disclose such policies and procedures to investors. These policies and procedures must include appropriate escalation measures to address anticipated or actual liquidity shortages, or other situations where the AIF becomes distressed.

Proposed Advice

Box 33

Liquidity Management Limits and Stress Tests

1. AIFMs shall, where appropriate, considering the nature, scale and complexity of each AIF they manage, implement and maintain adequate limits for the liquidity/illiquidity of the AIF consistent with its redemption policy in accordance with the overarching requirements in Box 29 (Risk Limits) relating to quantitative and qualitative limits. AIFMs shall monitor compliance with these limits and where the limits are exceeded or likely to be exceeded AIFMs shall determine what course of action is required.

2. In accordance with their obligations in Article 16 (1) of Directive 2011/61/EU AIFMs shall regularly conduct stress tests, under normal and exceptional liquidity conditions, which enable them to assess the liquidity risk of each AIF under their management. The stress tests shall:

   (a) be conducted on the basis of reliable and up-to-date information in quantitative terms or where this is not appropriate, in qualitative terms;

   (b) where appropriate, simulate a shortage of the liquidity of the assets in the AIF as well as atypical redemption requests;

   (c) cover market risks and any resulting impact, including on margin calls, on collateral requirements or credit lines;

   (d) account for valuation sensitivities under stressed conditions; and

   (e) be conducted at a frequency which is appropriate to the nature of the AIF, taking in to account the investment strategy, liquidity profile, type of investor and redemption policy of the AIF, but, at a minimum, annually.

3. AIFMs shall act in the best interests of investors in relation to the outcome of any stress tests. AIFMs shall consider the adequacy of the liquidity management policies and procedures, the appropriateness of the liquidity profile of the AIF's assets and the effect of atypical levels of redemption requests in determining any appropriate action.

Explanatory Text

26. The Directive does not require the use of limits as part of liquidity management. However, there are circumstances where the use of minimum limits regarding the liquidity/illiquidity of the AIF could pro-

vide an effective monitoring tool for certain types of AIFM. The text recognises that exceeding a limit may not of itself require action by the AIFM. This will depend on the facts and circumstances and the tolerances set by the AIFM. An example of where limits could be used in practice is in relation to monitoring average daily redemption versus fund liquidity in terms of days over the same period. This could also be used to monitor investor concentration to support stress testing scenarios. These limits could provide triggers for further discussion within the AIFM, continued monitoring or remedial action depending on the facts and circumstances.

27. In relation to the requirement to regularly conduct stress tests in both normal and exceptional circumstances, the advice recognises that it may not always be appropriate to prepare quantitative calculations and, where this is the case, a qualitative assessment should be performed. Such situations could arise where reliable or up to date quantitative information is not available to the AIFM and as a result they must base their assessment on qualitative factors. The advantage of using qualitative methods is that they generate more in-depth, comprehensive information that provide a context for behaviour. The focus upon processes and 'reasons why' differs from that of quantitative tests, which simply addresses correlations between variables. The financial crisis has shown that, especially in stressed conditions, risk characteristics can change rapidly as reactions by market participants within the system can induce feedback effects and lead to system-wide interactions. These effects can dramatically amplify initial shocks which are hard to model quantitatively. Qualitative expert judgment allows the development of innovative ad-hoc stress scenarios in such circumstances.

28. The stress tests should, where appropriate, simulate shortage of the liquidity of the assets as well as atypical redemption requests. Recent and expected future subscriptions and redemptions should be taken in to consideration together with the impact of anticipated AIF performance relative to peers on such activity. The AIFM should analyse the period of time required to meet redemption requests in the stress scenarios simulated. AIFM should also conduct stress tests on market factors such as foreign exchange movements or credit ratings which could materially impact the credit profile of the AIFM or that of the AIF and as a result collateral requirements. AIFM should account for valuation sensitivities under stressed conditions in its approach to stress testing/scenario analysis. In times of abrupt market fluctuations, situations can arise where market liquidity is much lower than usual, making it difficult to trade positions at observed market prices. In such circumstances, an AIF's net asset value may be difficult to calculate and where sales are attempted they may be very hard to realise. At the same time, the AIFM might be forced to sell positions in order to meet its underlying obligations such as margin calls/redemption requests and as a result it is important that these factors are considered as part of this process.

29. ESMA believes that it is not appropriate to mandate a set frequency at which stress tests should be conducted as this will depend on the investment strategy, liquidity profile, type of investor and the redemption policy of the AIF. However, it is expected that these tests shall be conducted at a minimum on an annual basis. Where stress tests suggest significantly higher than expected liquidity risk, the AIFM should act in the best interest of all AIF investors taking into consideration the liquidity profile of the AIF's assets, the level of redemption requests and where appropriate the adequacy of the liquidity management policies and procedures.

Proposed Advice

Box 34

Alignment of investment strategy, liquidity profile and redemption policy

1. For the purposes of Article 16 (2) of Directive 2011/61/EU the investment strategy, liquidity profile and redemption policy for each AIF managed by an AIFM shall be considered to be aligned when investors have the ability to redeem their investments:

   (a) in a manner consistent with the fair treatment of all AIF investors; and
   (b) in accordance with the AIF redemption policy and its obligations.

2. In assessing the alignment of the investment strategy, liquidity profile and redemption policy the AIFM shall also have regard to the impact that redemptions may have on the underlying prices and/or spreads of the individual assets of the AIF.

Explanatory Text

30. The Commission requests advice on the circumstances under which the investment strategy, liquidity profile and redemption policy for each AIF managed by an AIFM can be considered to be consistent.

31. ESMA's advice sets out the overarching principle that investors should be able to redeem their investments in accordance with the AIF policy, which should cover conditions for redemption in both normal and exceptional circumstances, and in a manner consistent with the fair treatment of investors. When referring to the fair treatment of investors, in this context, one of the factors that ESMA considers relevant is the impact on underlying prices and/or spreads of the individual assets of the AIF. This should capture appropriate use of gates, suspensions and side pockets. In response to the Commission's request, in relation to general principles, ESMA has set out in Box 19 criteria to assist competent authorities in assessing whether AIFM have treated all AIF investors fairly. These criteria should be taken in to account in assessing whether investors ability to redeem is consistent with the fair treatment of investors as a body.

32. AIFMs intending to invest in illiquid instruments should consider pre-launch the use of limited redemption restrictions and appropriate subscription/redemption frequency and ensure that the dealing frequency selected is appropriate for their investment strategy and assets. AIFMs should ensure that they retain the tools that they require to ensure that effective liquidity management is possible. Where there has been no material change in redemption levels or market circumstances but the investment strategy, liquidity profile and redemption policy are not aligned, ESMA considers that this would be a mismanagement of liquidity by the AIFM. ESMA may consider the development of further guidelines in this area to assist with implementation.

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

Q21: AIFMs which manage AIFs which are not closed ended (whether leveraged or not) are required to consider and put into effect any necessary tools and arrangements to manage such liquidity risks. ESMA's advice in relation to the use of tools and ar-

rangements in both normal and exceptional circumstances combines a principles based approach with disclosure. Will this approach cause difficulties in practice which could impact the fair treatment of investors?

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

IV.VI. Possible Implementing Measures on Investment in Securitisation Positions

Extract from the Commission's request

1. *CESR is invited to advise the Commission on the content of rules that are necessary and proportionate for an AIFM to fulfil its obligations under Article 17.*

2. *In particular, CESR is invited to advise on:*

   (a) the requirements to be met by the originator, the sponsor or the original lender, in order for an AIFM to be allowed to invest in securities as defined in Article 17.

   (b) the qualitative requirements to be met by an AIFM in order to comply with their obligations under Article 17.

   In developing this advice, CESR is invited to take full account of the content of the relevant articles of the Capital Requirements Directive and of measures developed for the same purpose in the context of other legislation, notably Solvency II.

Introduction

1. ESMA is requested to advise the Commission on the requirements for investment in securitisation positions by AIFM on behalf of one or more AIF (Article 17 AIFMD) or by UCITS (Article 63 AIFMD) with a view to ensuring cross-sectoral consistency and removing 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 of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast), and such AIFM (or UCITS respectively).

2. The parallel provisions of the CRD (Article 122a CRD), Solvency II (Article 135 Solvency II) and the advice given by CEBS[16] and CEIOPS[17] in this regard should be taken into account in order to ensure cross-sectoral consistency i.e. the investment in securitisation positions by credit institutions or insurance undertakings or AIFM on behalf of one or more AIF or UCITS should be subject to materially the same set of regulatory requirements in order to avoid any possibilities for regulatory arbitrage in this regard.

3. The relevant provisions of the CRD are more detailed than those provisions of Solvency II and the AIFMD. Given that CEIOPS' advice was based on the full set of the relevant provisions of the CRD, this policy for AIFM and UCITS should be based on CEIOPS' advice (and therefore at the same time be based on the relevant provisions of the CRD also taking into account CEBS' advice), making such amendments to CEIOPS' advice that are necessary due to the specific nature of the investment by an AIFM on behalf of one or more AIF (or UCITS respectively) in securitisation positions. This should

[16]CEBS Call for Technical Advice on the Effectiveness of a Minimum Retention Requirement for Securitisations, 30 October 2009, http://www.eba.europa.eu/documents/Publications/Advice/2009/article-122a/Advice.aspx

[17]CEIOPS Advice for Level 2 Implementing Measures on Solvency II: Repackaged Loans Investment, CEIOPS-DOC-59/10, 29 January 2010, https://eiopa.europa.eu/fileadmin/tx_dam/files/consultations/consultationpapers/CP63/CEIOPS-L2-Advice-Repackaged-loans-investment.pdf

provide for the desirable and proportionate level of cross-sectoral consistency requested by the Commission.

4. CEBS has issued further Guidelines[18] which deal with specific issues at a micro level that would not be appropriate to be fully taken into account for the purposes of this Level II policy. However, where appropriate, these further Guidelines were taken into account in order to achieve cross-sectoral consistency but without implementing all detailed requirements at a micro level with respect to neither different types of securitisations nor specific roles of parties to a securitisation transaction.

5. Certain concerns have been raised by the respondents to the call for evidence which ESMA has acknowledged and taken account of. It has been argued that 'actively managed securitisations' should be exempt from the retention requirement (versus 'balance sheet securitisations'). ESMA does not see an economic justification for such an exemption as the fundamental alignment of the interests of the relevant originator, sponsor or original lender to the interests of the investors may not be achieved by mere active management. In fact, the active management of e.g. a CLO may, depending on the specific economics of the transaction structure, make evident, that such CLO manager may be the person whose interests are most optimally aligned with those of the investors of the securitisation transaction. In these cases, the manager may 'opt in' to retain.

6. Further, it has been argued in response to the call for evidence that the main obligations arising from the new regulation with respect to investment in securitisation positions should be put on the parties to the securitisation transaction. ESMA is of the opinion that the overall horizontal regulatory approach contains a certain element of indirect regulation: The parties to the securitisation transaction are obliged to retain in order for an AIFM (or UCITS respectively) to be 'entitled' to make the investment. Thus the obligations are twofold (on the parties to the securitisation transaction and on the AIFM / UCITS). Any material deviation from this horizontal indirect approach would lead to possibilities for regulatory arbitrage.

7. Also, concerns have been raised with respect to the proportionality of possible grandfathering provisions. ESMA has adopted an approach that takes full account of the relevant provisions provided for by EBA / CEBS for the purposes of the CRD. In cases where certain residual legal uncertainty may prevail, ESMA considers that the legal consequences to a breach of the retention requirement were structured in a proportionate and sound way that ensures the interests of the investors of the AIF and also the respective AIFM (or UCITS as the case may be).

3. Appropriate requirements with respect to Article 17(1)(a) AIFMD: requirements that need to be met by the originator, the sponsor or the original lender

Box 35

Requirements for retained interest

1. AIFM should only assume exposure to tradable securities and other financial instruments based

[18] Guidelines to Article 122a of the Capital Requirements Directive, 31 December 2010, http://www.eba.europa.eu/Publications/Standards-Guidelines.aspx.

on repackaged loans on behalf of one or more AIF if the originator, sponsor or original lender has explicitly disclosed to the AIFM in the documentation governing the securitisation that it will retain, on an ongoing basis, a net economic interest which in any event should not be less than 5%. The net economic interest should be determined at the origination and, if later, at the date of assumption of exposure by the AIFM and should be maintained on an ongoing basis.

2. There are circumstances in which there are entities that meet the definition of originator or sponsor, or fulfil the role of original lender; however, another entity that neither meets the definition of sponsor or originator, nor fulfils the role of original lender – but whose interests are most optimally aligned with those of investors – may seek to fulfil the retention requirement. For the avoidance of doubt, such other entity is not obliged to fulfil the retention requirement according to paragraph 1 if the retention requirement is fulfilled by the originator, sponsor or original lender.

3. In cases where it becomes apparent to the AIFM after the assumption of exposure to the securitisation that the disclosure of the net economic interest was incorrect at the time of the assumption of the exposure, i.e. the disclosure did not meet all relevant requirements laid out in this advice, corrective action should be taken by the AIFM with respect to such exposure taking into account the best interests of the investors of the relevant AIF. In cases where the net economic interest to be retained becomes less than 5% at a given moment after the assumption of the exposure, the AIFM should consider such corrective action in the best interests of the investors of the relevant AIF.

4. There should be no multiple applications of the retention requirement for any given securitisation. Net economic interest should not be subject to any credit risk mitigation or any short positions or any other hedge and should not be sold. The net economic interest should be determined by the notional value for off-balance sheet items.

5. Paragraph 1 should not apply where the securitised exposures are claims or contingent claims on or wholly, unconditionally and irrevocably guaranteed by those institutions listed in CRD Article 122a(3), and should not apply to those transactions listed in CRD Article 122a(3).

General Considerations

8. These requirements were derived from Article 122a (1) and (3) CRD:

1. A credit institution, other than when acting as an originator, a sponsor or original lender, shall be exposed to the credit risk of a securitisation position in its trading book or non-trading book only if the originator, sponsor or original lender has explicitly disclosed to the credit institution that it will retain, on an ongoing basis, a material net economic interest which, in any event, shall not be less than 5 %.

[…]

Net economic interest is measured at the origination and shall be maintained on an ongoing basis. It shall not be subject to any credit risk mitigation or any short positions or any other hedge. The net economic interest shall be determined by the notional value for off-balance sheet items.

For the purpose of this Article, 'ongoing basis' means that retained positions, interest or exposures are not hedged or sold.

There shall be no multiple applications of the retention requirements for any given securitisation.

[…]

3. *Paragraph 1 shall not apply where the securitised exposures are claims or contingent claims on or fully, unconditionally and irrevocably guaranteed by:*

   (a) central governments or central banks;

   (b) regional governments, local authorities and public sector entities of Member States;

   (c) institutions to which a 50 % risk weight or less is assigned under Articles 78 to 83; or

   (d) multilateral development banks.

   Paragraph 1 shall not apply to:

   (a) transactions based on a clear, transparent and accessible index, where the underlying reference entities are identical to those that make up an index of entities that is widely traded, or are other tradable securities other than securitisation positions; or

   (b) syndicated loans, purchased receivables or credit default swaps where these instruments are not used to package and/or hedge a securitisation that is covered by paragraph 1.

9. For the avoidance of doubt, the term 'tradable securities and other financial instruments based on repackaged loans' is another way to refer to a securitisation. Please note that the retention requirement according to Box 1 paragraph 1 may also be satisfied on the basis of the consolidated situation that is further described in Art 122a(2) CRD.

The Assumption of Exposure

10. Please note that the term 'to assume exposure to' was used throughout this policy on investment in securitisation positions rather than the term 'to invest' in order to demonstrate and avoid any doubt that 'investment' in a securitisation position is not to be interpreted as a legal, valid and binding transfer of title with respect to the Notes (or other instruments) issued via a securitisation transaction to an AIFM on behalf of one or more AIF (or to the AIF directly from a legal perspective) but rather that it is sufficient in this regard that such 'investment' is made in a material economic sense, i.e. that any other forms of synthetic investments are covered and subject to the specific requirements laid out herein. Insofar, the term 'to assume exposure to' is only used for the purpose of clarification of a principle which is fundamentally implied in the definition of 'securitisation position' ('exposure to a securitisation'). Please also note that the relevant provisions of the CRD, especially Art 122a(1) CRD ('shall be exposed to') apply the same principle.

11. Further, please also refer to these excerpts from the CEBS Guidelines to Article 122a of the Capital Requirements Directive:

4. *As a general principle, for transactions which meet the definition of a securitisation under Article 4(36) of Directive 2006/48/EC (for instance, due to the tranching of credit risk), the provisions of Article 122a would typically apply.*

5. *The text of Article 122a makes a distinction between the requirements that are expected of:*

(i). credit institutions 'investing' in securitisations;

(ii). credit institutions assuming 'exposure' to securitisations; and

(iii). credit institutions acting as 'sponsors' or 'originators' of securitizations or securitised exposures.

6. *Paragraphs 1, 4 and 5 are framed around credit institutions investing in, or assuming exposure to, securitisations. In this respect, whether or not significant risk transfer is met under CRD by an originating credit institution is not pertinent.*

'An entity whose interests are most optimally aligned with those of the investors'

12. The CEBS Guidelines to Article 122a of the Capital Requirements Directive dated 31 December 2010[19] point out that, depending on the specific structure of the securitisation transaction, there may be a further entity involved which would not automatically qualify as originator, sponsor or original lender but which plays such a specific role in the overall structure that the interests of such entity are optimally aligned with the interests of the investors in the securitisation:

'There are circumstances in which there are entities that do indeed meet the definition of originator or sponsor, or fulfil the role of original lender; however, another entity that neither meets the definition of sponsor or originator, nor fulfils the role of original lender – but whose interests are most optimally aligned with those of investors – seeks instead to fulfil the retention requirement. Two (non-exhaustive) examples include the asset manager of a securitisation where there is ongoing management and substitution of exposures (where such asset manager is not a credit institution), or the most subordinated investor in a securitisation where such investor was also involved in structuring the transaction and selecting the exposures to be securitised (but is by definition neither the originator nor the sponsor, and nor is it the original lender). CEBS is aware that it is possible that such an entity could fulfil the retention requirement by means of an SPV that is established to act as 'originator' (for instance, by purchasing the exposures to be securitised), with such an SPV consequently meeting the definition of the term 'originator' under the Directive, but which then, in turn, has its retained credit risk assumed by (and potentially also its funding provided by) that entity that neither meets the definition of originator or sponsor nor fulfils the role of original lender. Where such arrangements are entered into, the primary consideration should be that retention is ultimately met by an entity with which alignment of interest is optimally achieved, and that this is not a mechanism for re-distributing the technically 'retained' exposure to other investors. To provide two specific examples, where the retained interest of such an 'originator' SPV was ultimately held by the asset manager of a collateralized loan obligation (hereafter 'CLO'), or by a subordinated investor involved in the selection of exposures and the structuring of tranches in a commercial mortgage backed security (hereafter 'CMBS'), these examples are both uses of an intermediate SPV that could ultimately ensure alignment of interest (when its retained interest is funded and credit risk is assumed by one of the above parties). However, where the retained interest of such an 'originator' SPV is sold on to other third-party investors with no involvement in the relevant securitisation, or to other funds managed by the asset manager that structured the relevant securitisation, this does not ensure alignment of interest. While it is not possible to cover all potential circumstances, this provides broad guidance for viewing such arrangements that meet the definition of 'originator' via the potential use of an SPV, but which must, nonetheless, ultimately ensure alignment of interest.'

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[19] http://www.eba.europa.eu/cebs/media/Publications/Standards%20and%20Guidelines/2010/Application%20of%20Art.%20122a%20of%20the%20CRD/Guidelines.pdf

13. ESMA believes that this approach should be applied mutatis mutandis with regard to the requirements for investment in securitisation positions under the AIFMD and has therefore included this approach in paragraph 2 of Box 35.

Legal Consequences of Breach of the Retention Requirement

14. The obligations of the AIFM in cases where the retention requirement is breached by the party to the securitisation transaction retaining (i.e. the relevant originator, sponsor or original lender), are set out in Box 35 paragraph 3.

15. In cases where it becomes apparent after the assumption of exposure that the retention requirement was not met at the time of the assumption of exposure, the AIFM is obliged to take corrective actions (e.g. hedge, sell or reduce exposure). In any case, the best interests of the investors should be taken into account when considering sound corrective actions. More specifically, there is no direct obligation to sell immediately after the breach has become apparent (no 'fire sale').

16. In cases where the net economic interest to be retained becomes less than 5% at a given moment after the assumption of the exposure, the AIFM should also consider corrective action in the best interests of the investors of the relevant AIF. In these cases, the AIFM should consider (i) selling or reducing the exposure or (ii) approaching the party in breach of the retention requirement with a view to getting back into compliance (with respect to the retention requirement).

17. In any case, a breach of the retention requirement by a specific party to a securitisation transaction should be taken into account by the AIFM when considering making another investment (assuming exposure that is) in a further transaction such party in breach is involved in. In these cases, the AIFM should only make further investments if the due diligence prior to such further investments comes to the conclusion (based on reasonable grounds) that the breach will not occur again.

No Multiple Applications and No Hedging

18. Box 35 paragraph 2 stipulates that there should be no multiple applications of the retention requirement and that there should be no hedging or other economic reduction of the retained interest. CEBS has developed Guidelines for the interpretation and application of these two major principles. There is no apparent reason why these principles should be applied differently when investment is made by an AIFM on behalf of one or more AIF.

19. The relevant provisions of the CEBS' Guidelines are:

> *38. The retention requirement should not be subject to any credit risk mitigation, any short position or any other hedge. Within the limits of what is practicable, material and could reasonably be expected to be within the control or knowledge of a credit institution, such credit institution should consider the economic substance of the transaction as a whole and consider whether any credit risk mitigation, short position or hedge essentially renders the retention ineffective.*
>
> *39. Notwithstanding this, the ability of certain types of hedging to undermine the application of the retention requirement, but for others not to, is recognised. The aim is to disallow hedging that*

eliminates a sponsor's, originator's or original lender's exposure to the credit quality of the specific exposures that have been securitised and to seek to balance this objective with another, of ensuring that sponsors, originators and original lenders still have sufficient flexibility to risk-manage their exposure to broader changes in the credit quality of the asset classes, collateral, or macroeconomic variables to which they are exposed via their lending activities, securitisation activities, or otherwise.

40. Given the above considerations, the following types of hedge are not deemed to be permissible:

a) A hedge on the credit risk of the securitisation positions that are retained specifically to fulfil the retention requirement is not permissible. For example, when the retention requirement is fulfilled using options (a), (b) or (d), the sponsor, originator or original lender should not buy protection on the retained position through a credit default swap.

b) A hedge on the credit risk of exposures that specifically fulfil the retention requirement is not permissible. For example, when the retention requirement is fulfilled using option (c), the sponsor, originator or original lender should not hedge the credit risk of the randomly selected exposures that it has retained.

41. When a sponsor, originator or original lender acts as a hedge counterparty to a securitisation (for instance, in hedging interest rate risk or currency risk), this is permissible, and is not intended to be captured under the term 'any other hedge'. For example, the originator, sponsor or original lender may act as counterparty to a securitisation in providing an interest rate hedge without being deemed to have 'hedged' its exposure to such securitisation.

42. In securitisations of trade receivables, originators sometimes purchase external credit insurance as part of the normal operating business. Similarly, mortgage guarantee insurance is sometimes taken out in respect of a pool of mortgage loans. Such types of insurance need not necessarily be considered to be 'hedges' of the underlying exposures, if undertaken as a legitimate and prudent element of credit-granting, and if their usage does not create a specific differentiation between the credit risk of (or the alignment of interest between) the retained positions or exposures and those positions or exposures that are sold to investors. For instance, mortgage guarantee insurance need not be considered a 'hedge' when loans in the pool of mortgages securitised – and to which both the originator and investors are equally exposed – benefit from such insurance. However, it could be considered a hedge if the securitised exposures do not benefit from mortgage guarantee insurance, but the exposures retained on balance sheet under option (c) do benefit from mortgage guarantee insurance. Similar considerations should apply to other forms of guarantee or insurance from which the exposures or positions of a securitisation may benefit.

[…]

61. The Directive requires that there 'shall be no multiple applications of the retention requirement'. The text does not mean that there is a prohibition on multiple applications; rather that, as outlined in Recital 24, it suffices that for any given securitisation only one of the originator, sponsor or original lender is subject to the requirement. Therefore, multiple application of the retention requirement by different parties to the transaction is not mandated by the Directive.

62. For a resecuritisation, from the perspective of the investor in that resecuritisation, fulfilment of the retention requirement would apply only to the second ('repackaged') layer of the transaction (in which it is investing), and not to the first ('underlying') layer of the transaction (i.e. the securitisations that underlie the second layer). More specifically, the phrase 'there shall be no multiple applications of the retention requirement' means that there shall be no requirement for multiple retention either by individual parties to the transaction or by individual SPVs within the structure of the transaction; however, there may be instances of multiple retention at the overall transaction level as an outcome of the resecuritisation process itself. For instance, where a

transaction is the resecuritisation of existing securitisations, this may result in retention occurring at more than one level in the overall transaction (i.e. in both the underlying securitisations and in the newly created resecuritisation). However, this is an outcome of the resecuritisation process itself, and is not necessary to fulfil the requirements of Article 122a. Conversely, if the presence of two SPVs in a transaction is the result of the transaction's overall legal structure or the securitisation law of individual jurisdictions (e.g. the need for a discrete borrower SPV and an issuer SPV, or financing via certain co-funding structures that require more than one SPV), this will neither require multiple application of retention under Article 122a, nor will it necessarily indirectly lead to multiple retention as an outcome. However, both in the context of resecuritisations and more generally, credit institutions should be particularly sensitive to the use of intermediating SPVs, and should not invest in structures which may result in avoidance of the economic substance of the retention requirement.

63. *Although for a resecuritisation there is no requirement for the investing credit institution to ensure that retention is met also at the first layer (i.e. the underlying securitisations), as it is only required to do so at the second layer (in which the investment is made), it could be the case that credit institutions investing or assuming exposure to such resecuritisations deem information on whether retention at this first layer is met or not to be material for credit analysis (in fulfilling their obligations under Paragraphs 4 and 5), or credit institutions acting as sponsors or originators deem such information to be material for the purposes of transparency and disclosure (in fulfilling their obligations under Paragraph 7).*

Exemptions

20. A number of exemptions apply to the requirements for being exposed to the credit risk of securitisation positions in the CRD that, in the interests of cross-sectoral consistency, ESMA considers should also apply to AIFM that invest in tradable securities and other financial instruments based on repackaged loans on behalf of one or more AIF (please refer to Box 35 Paragraph 5).

Box 36

Requirements for sponsors and originator credit institutions

1. Prior to an AIFM assuming exposure to tradable securities and other financial instruments based on repackaged loans on behalf of one or more AIF, it is required that the AIFM should ensure that the sponsor, originator credit institution or original lender (as applicable):

   - base credit granting (such as the issuance of loans or mortgages) on sound and well-defined criteria and clearly establish the process for approving, amending, renewing, and re-financing loans to the exposures to be securitised as they apply to exposures they hold;

   - operate effective systems to manage the ongoing administration and monitoring of its various credit risk-bearing portfolios and exposures, including for identifying and managing problem loans and for making adequate value adjustments and provisions;

   - diversify adequately each credit portfolio given its target market and overall credit strategy; and

   - maintain documentation to include its policy for credit risk, including its risk appetite and provisioning policy and should describe how it measures, monitors and controls that risk.

General Considerations

21. The requirement is derived from Article 122a(6), sub paragraph 1 CRD and Annex V(3) CRD[20] (Credit and Counterparty Risk).

Article 122a(6), sub paragraph 1 CRD reads:

> 6. *Sponsor and originator credit institutions shall apply the same sound and well-defined criteria for credit-granting in accordance with the requirements of Annex V, point 3 to exposures to be securitised as they apply to exposures to be held on their book. To this end the same processes for approving and, where relevant, amending, renewing and refinancing credits shall be applied by the originator and sponsor credit institutions. Credit institutions shall also apply the same standards of analysis to participations or underwritings in securitisation issues purchased from third parties whether such participations or underwritings are to be held on their trading or non-trading book.*

Annex V(3) CRD reads:

> *TECHNICAL CRITERIA CONCERNING THE ORGANISATION AND TREATMENT OF RISKS*
>
> *[...]*
>
> *3. CREDIT AND COUNTERPARTY RISK*
>
> *3. Credit-granting shall be based on sound and well-defined criteria. The process for approving, amending, renewing, and re-financing credits shall be clearly established.*
>
> *4. The ongoing administration and monitoring of their various credit risk-bearing portfolios and exposures, including for identifying and managing problem credits and for making adequate value adjustments and provisions, shall be operated through effective systems.*
>
> *5. Diversification of credit portfolios shall be adequate given the credit institution's target markets and overall credit strategy.*

Scope of Due Diligence Obligation

22. Prior to an AIFM assuming relevant exposure, the AIFM should ensure that the sponsor, originator credit institution or original lender (as applicable) maintains adequate standards of credit policy. There are natural limits to such due diligence obligation of an AIFM (e.g. the AIFM should not be obliged to interview the work force of a credit institution or actually perform an onsite due diligence based on the internal documentation of the credit institution).

23. Therefore, the AIFM should satisfy on a best efforts basis that the requirements are met by the respective party of the securitisation transaction. This could for instance be done via a request in written form to disclose any material aspects (e.g. in the form of an executive summary) which are eligible to make evident that the requirements according to Box 2 paragraph 1 are satisfied. Further, the respective party of the securitisation transaction should covenant to give immediate notice in case the fulfilment

[20] Directive 2006/48/EC in this case.

of the requirements according to Box 2 paragraph 1 is in doubt or in case such requirements are even breached (e.g. according to an internal audit report).

Box 37

Requirements for transparency and disclosure of retention

1. Prior to an AIFM assuming exposure to tradable securities and other financial instruments based on repackaged loans on behalf of one or more AIF, the AIFM should ensure that the sponsor, originator or original lender (as applicable) discloses to the AIFM the level of their commitment as laid down in Box 35 paragraph 1 to maintain a sufficient net economic interest in the securitisation. The relevant sponsor, originator or original lender should also disclose any features of the holding that would undermine the concept of its retained interest, such as commission payments and should ensure that the AIFM has readily available access to all materially relevant data on the credit quality and performance of the individual underlying exposures, cash flows and collateral supporting a securitisation exposure as well as such information that is necessary to conduct comprehensive and well informed stress tests on the cash flows and collateral values supporting the underlying exposures. For that purpose, materially relevant data should be determined as at the date of the securitisation and where appropriate due to the nature of the securitisation thereafter.

General Considerations

24. The requirement is based on these relevant provisions of Article 122a(1) CRD:

> 1. *A credit institution, other than when acting as an originator, a sponsor or original lender, shall be exposed to the credit risk of a securitisation position in its trading book or non-trading book only if the originator, sponsor or original lender* ***has explicitly disclosed*** *to the credit institution that it will retain, on an ongoing basis, a material net economic interest which, in any event, shall not be less than 5 %.*
>
> *[…]*
>
> *Net economic interest is measured at the origination and shall be maintained on an ongoing basis. It shall not be subject to any credit risk mitigation or any short positions or any other hedge. The net economic interest shall be determined by the notional value for off-balance sheet items.*
>
> *For the purpose of this Article, 'ongoing basis' means that retained positions, interest or exposures are not hedged or sold.*

25. The purpose of requiring this is to allow the AIFM to understand the impact of features that could have an impact on the retention requirement (e.g. variable commission payments).

Disclosure

26. CEBS has issued Guidelines on the specific modes in which the 'disclosure' may be made. These Guidelines should also be applicable if exposure is assumed by an AIFM. The relevant provisions of CEBS Guidelines to Article 122a of the Capital Requirements Directive read:

37. *The disclosure by an originator, sponsor or original lender of its fulfilment of the retention requirement should be made available publicly and should be appropriately documented; for instance, a reference to the retention commitment in the prospectus for securities issued under that securitisation programme would be considered appropriate. Such disclosures may be made privately where appropriate (for example, a bi-lateral or private transaction); however, oral disclosures will not be adequate to demonstrate compliance. The disclosure should be made at origination of the transaction, and should be confirmed thereafter with the same frequency as the reporting frequency of the transaction (but, at a minimum, annually), and at any point where the requirement is breached. The reporting frequency of the transaction would typically be the frequency with which the servicer report, investor report, trustee report, or any similar document is published.*

Relevant Data

27. In order to comply with the obligations imposed on the relevant party of the securitisation transaction, such party should provide full insight into the structural features of the securitisation transaction with respect to the funding level and the asset level. In order to avoid any doubt with respect to the information that should be readily available, the parallel requirements stipulated in Art 122a(7) CRD were implemented in Box 37. Please note that the information that should be readily available may also form the basis for stress testing by the AIFM.

4. Appropriate requirements with respect to Article 17(1)(b) AIFMD: qualitative requirements that must be met by AIFM

Box 38

Requirements for risk and liquidity management

1. AIFM assuming exposure to tradable securities and other financial instruments based on repackaged loans on behalf of one or more AIF need, in order to fulfil their obligations imposed by Articles 15 and 16 AIFMD, to be able to properly identify, measure, monitor, manage, control and report the risks of these products and should pay particular attention to assessing the ALM risks, i.e. risks that arise due to mismatches between the assets and liabilities of the relevant AIF, concentration risk and investment risk arising from these products. AIFM that assume exposure to these products on behalf of one or more AIF should also particularly ensure that the risk profile of such securitisation positions corresponds to the size, overall portfolio structure, investment strategies and objectives of the relevant AIF as laid down in the AIF rules or instruments of incorporation, prospectus and offering documents.

28. Any investment in securitised products should be properly reflected in the internal risk and liquidity management (as any other investment). Therefore, Box 38 paragraph 1 sentence 1 is partially based on the general provision of Article 15(2) sub paragraph 1 AIFMD (Risk management).

29. In order to point out the particular importance of a properly functioning risk and liquidity management when making such investments, Box 38 paragraph 1 puts a particular focus on (for the avoidance of any doubt) the ALM, concentration and investment risk. Further, sentence 2 of this requirement aligns Box 4 paragraph 1 (based on 3.54 CEIOPS' Advice) to the wording of Article 15(3)(c) AIFMD.

30. Article 15(2) sub paragraph 1 AIFMD reads:

2. *The AIFM shall 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.*

31. Article 15(3)(c) AIFMD reads:

The AIFM shall at least:

[…]

(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.

Box 39

Requirements for monitoring procedures

1. AIFM should establish formal monitoring procedures in line with the principles set out in Article 15 AIFMD commensurate with the risk profile of the relevant AIF in relation to tradable securities and other financial instruments based on repackaged loans to monitor on an on-going basis and, in a timely manner, performance information on the exposures underlying such securitisation positions. AIFM need to have access to relevant information to be able to perform this analysis. Such information includes (if relevant to the specific type of securitisation and not limited to such types of information further described herein), the exposure type, the percentage of loans more than 30, 60 and 90 days past due, default rates, prepayment rates, loans in foreclosure, collateral type and occupancy, frequency distribution of credit scores or other measures of credit worthiness across underlying exposures, industry and geographical diversification and frequency distribution of loan to value ratios with bandwidths that facilitate adequate sensitivity analysis. Where the underlying exposures are themselves securitisation positions, AIFM should have such relevant information not only on the underlying securitisation tranches, such as the issuer name and credit quality, but also on the characteristics and performance of the pools underlying those securitisation tranches.

32. Article 15 AIFMD contains specific monitoring requirements for all types of AIF. The language of Box 39 paragraph 1 is based on the relevant provisions of CEIOPS' advice and additionally on the definition of certain types of relevant information laid down in Article 122a(5) CRD for the purpose of stressing that the investment in securitised products requires a more thoroughly structured monitoring process than the monitoring process required if investing in other assets.

33. Further, taking into account the parallel provision of Article 122a(5) sub paragraph 2 CRD, in order to fulfil the requirements for monitoring procedures, it is evident that the AIFM should have a thorough understanding of all structural features of a securitisation transaction that would materially impact the performance of the assumed exposures to the transaction such as the contractual waterfall and water-fall related triggers, credit enhancements, liquidity enhancements, market value triggers, and deal-specific definition of default.

34. In cases of doubt with respect to the minimum set of information that should be readily available to the AIFM (and ultimately the competent authorities), Box 5 paragraph 1 should be interpreted in the light of Article 122a(4) CRD which reads:

> *4. Before investing, and as appropriate thereafter, credit institutions, shall be able to demonstrate to the competent authorities for each of their individual securitisation positions, that they have a comprehensive and thorough understanding of and have implemented formal policies and procedures appropriate to their trading book and non-trading book and commensurate with the risk profile of their investments in securitised positions for analysing and recording:*
>
> *(a) information disclosed under paragraph 1, by originators or sponsors to specify the net economic interest that they maintain, on an ongoing basis, in the securitisation;*
>
> *(b) the risk characteristics of the individual securitisation position;*
>
> *(c) the risk characteristics of the exposures underlying the securitisation position;*
>
> *(d) the reputation and loss experience in earlier securitisations of the originators or sponsors in the relevant exposure classes underlying the securitisation position;*
>
> *(e) the statements and disclosures made by the originators or sponsors, or their agents or advisors, about their due diligence on the securitised exposures and, where applicable, on the quality of the collateral supporting the securitised exposures;*
>
> *(f) where applicable, the methodologies and concepts on which the valuation of collateral supporting the securitised exposures is based and the policies adopted by the originator or sponsor to ensure the independence of the valuer; and*
>
> *(g) all the structural features of the securitisation that can materially impact the performance of the credit institution's securitisation position.*

Box 40

Requirements for stress tests

1. Where an AIFM has assumed exposure to (on behalf of one or more AIF) a material value of tradable securities and other financial instruments based on repackaged loans, the AIFM should regularly perform stress tests according to Article 15 paragraph 3(b) AIFMD appropriate to such securitisation positions simultaneously taking into account the dynamic effects of the stress test scenario on the remaining assets of the relevant AIF, i.e. the dynamic effects on such other positions that are not securitisation positions (if any).

35. The requirement arises due to the stress testing requirement of the Level 1 text. The wording is based on the relevant provision of CEIOPS' advice setting out that the stress test under Solvency II should simultaneously take into account the dynamic effects of the stress test scenario on the rest of their (i.e. an insurance undertaking's) business. For the purposes of securitisation positions being part of the portfolio of assets of an AIF, such simultaneous consideration should be made with respect to the remaining assets of the relevant AIF, i.e. such other positions that are not securitisation positions.

36. Please note that Article 122a(4) sub paragraph 2 CRD provides for a stress testing requirement for credit institutions. Box 6 should be interpreted in the light of these provisions of the CRD which read:

> *Credit institutions shall regularly perform their own stress tests appropriate to their securitisation positions. To this end, credit institutions may rely on financial models developed by an ECAI provided that credit institutions can demonstrate, when requested, that they took due care prior to investing to validate the relevant assumptions in and structuring of the models and to understand methodology, assumptions and results.*

Box 41

Requirements for formal policies, procedures and reporting

1. Before assuming exposure to tradable securities and other financial instruments based on repackaged loans on behalf of one or more AIF, and as appropriate thereafter, an AIFM should be able to demonstrate in line with the requirements set out in Article 18 AIFMD to its competent supervisory authorities that for each of such individual securitisation positions it has a comprehensive and thorough understanding of and has implemented formal policies and procedures appropriate to the investment portfolio of the relevant AIF. These formal policies and procedures should be commensurate to the risk profile of such exposure to a securitisation.

2. AIFM should also ensure in line with the requirements set out in Article 18 AIFMD that there is an adequate level of internal reporting to the senior management so that these persons are aware of any material assumption of exposure to repackaged loans and that the risks arising from the assumption of exposure to these products are adequately managed.

3. AIFM should also include appropriate information on their exposure to these products, and their risk management procedures in this area, in the reports and disclosures according to Article 22 to 24 AIFMD.

37. There are minor amendments to the relevant provision of CEIOPS' advice taking into account that an AIFM does not act on behalf of its own business / assets but rather on behalf of one or more AIF. In case of an internally managed AIF it is self-understood that reference is made to the 'AIF-Component' of the relevant legal entity.

38. Also, the necessary internal reporting should be made to the senior management. As the AIFMD contains specific reporting and disclosure requirements, reference should be made to these specific provisions in order to avoid any doubt that such reporting and disclosure requirements are of specific importance when exposure is assumed to securitised products.

5. Grandfathering Provisions

Box 42

Introduction of new underlying exposures to existing securitisations

1. For AIFM that have assumed exposure to tradable securities and other financial instruments based on repackaged loans on behalf of one or more AIF that were issued before 1 January 2011, the above requirements should apply from 31 December 2014 where new underlying exposures

are added or substituted after that date.

39. The provision aligns Article 122a(8) CRD, Paragraph 3.60. of CEIOPS' advice and this policy for AIFM (and UCITS respectively). CEBS has provided detailed Guidelines for interpreting the respective Grandfathering Provisions of the CRD. Box 42 should be interpreted in the light of these Guidelines in order to achieve cross-sectoral consistency.

6. Article 63 AIFMD: Amendment of Directive 2009/65/EC (UCITS)

Box 43

Investments by UCITS

1. All requirements set out above should be equally applicable to UCITS assuming exposure to tradable securities and other financial instruments based on repackaged loans according to the limits of the UCITS Directive.

2. For the purpose of the transition of the requirements set out above applicable to AIFM to UCITS, any reference made above to an AIFM assuming relevant exposure on behalf of an AIF should in the case of a UCITS be construed as a reference to such management company or other person within the meaning of the UCITS Directive managing and administrating such relevant UCITS.

3. Further, for the purpose of the transition of the requirements set out above applicable to AIFM to UCITS, any reference made above to the relevant provisions of the AIFMD should be construed as a reference to such relevant legal obligations of the UCITS Directive applicable to UCITS.

40. There should be no deviation with respect to regulatory requirements applicable to UCITS from those applicable to AIFM as there are no sufficient material differences between these two with respect to the investment in tradable securities and other financial instruments based on repackaged loans that could reasonably justify such deviation.

41. The provisions in Box 43 were drafted with a view to incorporating the principles applicable to AIFM into the regulatory framework applicable to UCITS by way of reference. The alternative way of structuring such regulatory provisions applicable to UCITS would be to literally 'repeat' all requirements applicable to AIFM and make minor amendments to the wording with a view to explicitly stating that each of the provisions are applicable to UCITS accordingly.

IV.VII. Possible Implementing Measures on Organisational Requirements

Extract from the Commission mandate

1. *CESR is invited to advise the Commission on the content of rules that are proportionate and necessary for specifying the general obligations placed on an AIFM by Article 18(1).*

2. *In particular, CESR is requested to advise on the procedures and arrangements to be implemented by the AIFM, having regards to the nature of the AIF managed by the AIFM in order to comply with its obligations under Article 18(1).*

Introduction

1. ESMA is requested to advise the Commission on the content of rules that are proportionate and necessary for the specification of the general obligations placed on an AIFM by Article 18(1) of the AIFMD.

2. Most of the respondents to the call for evidence took the view that both UCITS and MiFID rules should serve as a starting point. They emphasized that in many cases AIFM act as management companies under the UCITS Directive or as investment firms under the MiFID Directive so that consistency would be desirable. Furthermore, respondents felt that the AIFMD implementing measures should be proportionate to the size and scale of the AIFM's business.

3. In line with the Commission' s request this advice seeks to achieve an appropriate level of consistency with the UCITS and MiFID regime while taking into account the particularities of AIF and the diverse assets they may be invested in. Many AIFM are already authorized as management companies under the UCITS Directive or are already operating under the MiFID regime. A consistent approach with existing regulatory standards applicable to management companies under the UCITS Directive or investment firms under the MiFID Directive avoids that those AIFM that also operate as management companies or investment firms have to comply with different or overlapping regulatory standards in relation to their business.

4. Furthermore, this advice takes into account the principle of proportionality: Organizational requirements should be applied proportionately in view of the nature, scale and complexity of the AIFM's business and the nature and range of its activities.

Box 44

General requirements on procedures and organisation

1. AIFM should comply with the following requirements:

   (a) to establish, implement and maintain decision-making procedures and an organisational structure which clearly and in a documented manner specifies reporting lines and allocates functions and responsibilities;

   (b) to ensure that their relevant persons are aware of the procedures which must be followed for the proper discharge of their responsibilities;

   (c) to establish, implement and maintain adequate internal control mechanisms designed to secure compliance with decisions and procedures at all levels of the AIFM;

   (d) to establish, implement and maintain effective internal reporting and communication of information at all relevant levels of the AIFM as well as effective information flows with any third party involved;

   (e) to maintain adequate and orderly records of their business and internal organisation.

   AIFM should take into account the nature, scale and complexity of their business and the nature and range of services and activities undertaken in the course of that business.

2. AIFM should establish, implement and maintain systems and procedures that are adequate to safeguard the security, integrity and confidentiality of information, taking into account the nature of the information in question.

3. AIFM should establish, implement and maintain an adequate business continuity policy aimed at ensuring, in the case of an interruption to their systems and procedures, the preservation of essential data and functions, and the maintenance of services and activities, or, where that is not possible, the timely recovery of such data and functions and the timely resumption of their services and activities.

4. AIFM should establish, implement and maintain accounting policies and procedures that enable them, at the request of the competent authority, to deliver in a timely manner to the competent authority financial reports which reflect a true and fair view of their financial position and which comply with all applicable accounting standards and rules.

5. AIFM should monitor and, on a regular basis, evaluate the adequacy and effectiveness of their systems, internal control mechanisms and arrangements established in accordance with paragraphs 1 to 4, and to take appropriate measures to address any deficiencies.

Explanatory text

5. Box 44 covers general principles of procedures and organisation AIFM have to comply with, e.g. specification of reporting lines, allocation of functions and responsibilities or establishment of effective internal reporting. These provisions are based on Article 4 UCITS Level 2 and Article 5 MiFID Level 2.

6. When establishing and implementing the necessary procedures and organisational structure AIFM should take into account the principle of proportionality, i.e. the procedures, mechanisms and organ-

isational structure as required under paragraph 1 (a) to (e) should be calibrated to the nature, scale and complexity of the AIFM's business and to the nature and range of services and activities carried out in the course of this business.

Box 45

Resources

1. AIFM should employ sufficient personnel with the skills, knowledge and expertise necessary for the discharge of the responsibilities allocated to them.

2. AIFM should ensure that the performance of multiple functions by relevant persons does not and is not likely to prevent those relevant persons form discharging any particular function soundly, honestly and professionally.

3. For the purposes laid down in paragraphs 1and 2, AIFM should take into account the nature, scale and complexity of their business and the nature and range of services and activities undertaken in the course of that business.

Explanatory text

7. Box 45 requires AIFM to employ personnel with the necessary skills, knowledge and expertise to carry out the tasks assigned to them. The provisions are based on Article 5 UCITS Level 2.

Box 46

Electronic data processing

1. AIFM should make appropriate arrangements for suitable electronic systems so as to permit a timely and proper recording of each portfolio transaction or subscription or, where relevant, redemption order.

2. AIFM should ensure a high level of security during the electronic data processing as well as integrity and confidentiality of the recorded information, as appropriate.

Explanatory text

8. In line with the UCITS approach (Article 7 UCITS Level 2) AIFM should ensure the employment of suitable electronic systems in order to fulfil the recording requirements according to Boxes 52 and 53 (Recording of portfolio transactions and Recording of subscription and redemption orders).

Box 47

Accounting procedures

1. AIFM should employ accounting policies and procedures as referred to in B.1 paragraph 4 (general requirements on procedures and organisation) so as to ensure the protection of investors. AIF accounting shall be kept in such a way that all assets and liabilities of the AIF can be directly identified at all time. If an AIF has different investment compartments, separate accounts shall be maintained for those investment compartments.

2. AIFM should establish, implement and maintain accounting policies and procedures so as to ensure the calculation of the net asset value of each AIF is accurately effected on the basis of the accounting.

Explanatory text

9. In line with the UCITS approach (Article 8 UCITS Level 2) AIFM should establish, implement and maintain accounting policies and procedures to ensure that the calculation of the net asset value is carried out according to Article 19 AIFMD.

Box 48

Control by senior management and supervisory function

1. When allocating functions internally, AIFM should ensure that senior management and, where appropriate, the supervisory function, are responsible for the AIFM's compliance with its obligations under the AIFM-Directive.

2. The AIFM should ensure that its senior management

   (a) is responsible for the implementation of the general investment policy for each managed AIF, as defined, where relevant, in the fund rules, the instruments of incorporation, the prospectus or offering documents;

   (b) approves or oversees the approval of the investment strategies for each managed AIF;

   (c) is responsible for ensuring that valuation procedures according to Article 19 of the AIFM Directive are established;

   (d) is responsible for ensuring that the AIFM has a permanent and effective compliance function, even if this function is performed by a third party;

   (e) ensures and verifies on a periodic basis that the general investment policy, the investment strategies and the risk limits of each managed AIF are properly and effectively implemented and complied with, even if the risk management function is performed by third parties;

   (f) approves and reviews on a periodic basis the adequacy of the internal procedures for undertaking investment decisions for each managed AIF, so as to ensure that such decisions are consistent with the approved investment strategies;

   (g) approves and reviews on a periodic basis the risk management policy and arrangements, processes and techniques for implementing that policy including the risk limit system for each managed AIF;

(h) is responsible for establishing and applying a remuneration policy in line with Annex II of the AIFM-Directive..

3. The AIFM should also ensure that its senior management and, where appropriate, its supervisory function should:

(a) assess and periodically review the effectiveness of the policies, arrangements and procedures put in place to comply with the obligations in the AIFM-Directive;

(b) take appropriate measures to address any deficiencies.

4. AIFM should ensure that their senior management receives on a frequent basis, and at least annually, written reports on matters of compliance, internal audit and risk management indicating in particular whether appropriate remedial measures have been taken in the event of any deficiencies.

5. AIFM should ensure that their senior management receives on a regular basis reports on the implementation of investment strategies and of the internal procedures for taking investment decisions referred to in points (b) to (e) of paragraph 2.

6. AIFM should ensure that the supervisory function, if any, receives on a regular basis written reports on the matters referred to in paragraph 4.

Explanatory text

10. In line with the UCITS approach (Article 9 UCITS Level 2) the provisions of Box 48 set out the roles and responsibilities of the senior management and the supervisory function (if any). In this respect paragraph 2(b) of Box 48 lists the responsibility of the senior management to either approve or oversee the approval of the investment strategies for each managed AIF. When the AIF is constituted under the law of contract and has no legal personality, the first alternative is applicable, i.e. the senior management of the AIFM approves the investment strategies. When the AIF is constituted under statute, has a legal personality and has appointed an AIFM, the second alternative is applicable.

11. ESMA acknowledges that the roles and responsibilities of the senior management and the supervisory function may differ in Member States according to the relevant national (corporate) law. Therefore, the provisions of Box 48 should be applied in consistency with the relevant applicable national (corporate) law in each Member State.

12. If the relevant national law provides a dual board system, the term 'supervisory function' refers to the supervisory board. If there is no dual system, the term 'supervisory function' refers to non-executive directors.

Box 49

Permanent compliance function

1. AIFM should establish, implement and maintain adequate policies and procedures designed to detect any risk of failure by the AIFM to comply with its obligations under the AIFM-Directive, as well as the associated risks, and put in place adequate measures and procedures designed to minimise such risk and to enable the competent authorities to exercise their powers effectively under that Directive.

AIFM should take into account the nature, scale and complexity of their business, and the nature and range of services and activities undertaken in the course of that business.

2. AIFM should establish and maintain a permanent and effective compliance function which operates independently and which has the following responsibilities:

   (a) to monitor and, on a regular basis, to assess the adequacy and effectiveness of the measures, policies and procedures put in place in accordance with paragraph 1, and the actions taken to address any deficiencies in the AIFM's compliance with its obligations;

   (b) to advise and assist the relevant persons responsible for carrying out services and activities to comply with the AIFM's obligation under the AIFM-Directive.

3. In order to enable the compliance function referred to in paragraph 2 to discharge its responsibilities properly and independently, AIFM shall ensure that the following conditions are satisfied:

   (a) the compliance function must have the necessary authority, resources, expertise and access to all relevant information;

   (b) a compliance officer must be appointed and must be responsible for the compliance function and for any reporting on a frequent basis, and at least annually, to the senior management on matters of compliance, indicating in particular whether the appropriate remedial measures have been taken in the event of any deficiencies;

   (c) the relevant person involved in the compliance function must not be involved in the performance of services or activities they monitor;

   (d) the method of determining the remuneration of the relevant persons involved in the compliance function must not compromise their objectivity and must not be likely to do so.

   However, an AIFM shall not be required to comply with point (c) or point (d) of the first subparagraph where it is able to demonstrate that in view of the nature, scale and complexity of its business, and the nature and range of its services and activities, that requirement is not proportionate and that its compliance function continues to be effective.

Explanatory text

13. ESMA recommends that AIFM should establish and maintain a permanent and effective compliance function which operates independently. This approach is in line with the approach under UCITS (Article 10 UCITS Level 2) and MiFID (Article 6 MiFID Level 2).

14. The requirement to have a permanent and effective compliance function should always be fulfilled by the AIFM irrespective of size and complexity of its business. However, details of technical and personnel organization of the compliance function should be calibrated to nature, scale and complexity of the AIFM's business and the nature and range of its services and activities.

15. Furthermore, the AIFM has to ensure that the compliance function operates independently. Paragraph 3 sets out the conditions that have to be fulfilled in order to meet this requirement, e.g. appointment of a compliance officer or necessary authority and resources of the compliance function. ESMA believes

that, as a general rule, the AIFM should establish an independent compliance unit. However, the AIFM should not be required to establish an independent compliance unit if this would be disproportionate due to the size of the AIFM or the nature, scale and complexity of the AIFM's business. For example, appointing a separate compliance officer may be disproportionate for AIFM the business of which is of small size and entails a lower risk to constitute conflicts of interest. The AIFM should document the reasons why the establishment of an independent compliance unit would be disproportionate.

16. In addition to this it is required that relevant persons involved in the compliance function must not be involved in the activities they monitor and that the remuneration policy must not impair their objectivity. Where these latter requirements are not proportionate to the size and complexity of the AIFM's business, the last paragraph in Box 49 provides an exemption rule. If the AIFM makes use of the exemption rule, it should document the reasons for making use of the exemption.

17. If the compliance function is carried out by a third party, the AIFM has to supervise that the third party meets the requirements set out in Box 49.

Box 50

Permanent internal audit function

1. AIFM should, where appropriate and proportionate in view of the nature, scale and complexity of their business and the nature and range of collective portfolio management activities undertaken in the course of that business, establish and maintain an internal audit function which is separate and independent from the other functions and activities of the AIFM.

2. The internal audit function referred to in paragraph 1 shall have the following responsibilities:

   (a) to establish, implement and maintain an audit plan to examine and evaluate the adequacy and effectiveness of the AIFM's systems, internal control mechanisms and arrangements;

   (b) to issue recommendations based on the result of work carried out in accordance with point (a);

   (c) to verify compliance with the recommendations referred to in point (b);

   (d) to report in relation to internal audit matters.

Explanatory text

18. In line with the UCITS (Article 11 UCITS Level 2) and the MiFID (Article 8 Level 2) approach AIFM should establish and maintain an internal audit function separate and independent from other functions and activities of the AIFM. In case this separation and independence should be disproportionate to the scale and complexity of the AIFM's business, the responsibilities of the internal audit function may be carried out by another business unit of the AIFM.

Box 51

Personal transactions

1. AIFM should establish, implement and maintain adequate arrangements aimed at preventing the following activities in the case of any relevant person who is involved in activities that may give rise to a conflict of interest, or who has access to inside information within the meaning of Article 1(1) of Directive 2003/6/EC or to other confidential information relating to AIF or transactions with or for AIF by virtue of an activity carried out by him on behalf of the management company:

   (a) entering into a personal transaction which fulfils at least one of the following criteria:

      (i) that person is prohibited from entering into that personal transaction within the meaning of Directive 2003/6/EC;

      (ii) it involves the misuse or improper disclosure of confidential information;

      (iii) it conflicts or is likely to conflict with an obligation of the AIFM under the AIFMD;

   (b) advising or procuring, other than in the proper course of his employment or contract for services, any other person to enter into a transaction in financial instruments or other assets which, if a personal transaction of the relevant person, would be covered by point (a) of this paragraph or by points (a) or (b) of Article 25(2) of Directive 2006/73/EC, or would otherwise constitute a misuse of information relating to pending orders;

   (c) disclosing, other than in the normal course of his employment or contract for services and without prejudice to Article 3(a) of Directive 2003/6/EC, any information or opinion to any other person if the relevant person knows, or reasonably ought to know, that as a result of that disclosure that other person will or would be likely to take either of the following steps:

      (i) to enter into a transaction in financial instruments or other assets which, where a personal transaction of the relevant person would be covered by point (a) of this paragraph or by points (a) or (b) of Article 25(2) of Directive 2006/73/EC, or would otherwise constitute a misuse of information relating to pending orders;

      (ii) to advise or procure another person to enter into such a transaction.

2. The arrangements required under paragraph 1 shall in particular be designed to ensure that:

   (a) each relevant person covered by paragraph 1 is aware of the restrictions on personal transactions, and of the measures established by the AIFM in connection with personal transactions and disclosure, in accordance with paragraph 1;

   (b) the AIFM is informed promptly of any personal transaction entered into by a relevant person covered by paragraph 1, either by notification of that transaction or by other procedures enabling the AIFM to identify such transactions;

   (c) a record is kept of the personal transaction notified to the AIFM or identified by it, including any authorisation or prohibition in connection with such a transaction.

   For the purposes of point (b) of the first subparagraph, where certain activities are performed by third parties, the AIFM shall ensure that the entity performing the activity maintains a record of personal transactions entered into by any relevant person covered by paragraph 1 and provides that information to the AIFM promptly on request.

3. Paragraphs 1 and 2 shall not apply to the following kind of personal transactions:

(a) personal transactions effected under a discretionary portfolio management service where there is no prior communication in connection with the transaction between the portfolio manager and the relevant person or other person for whose account the transaction is executed;

(b) personal transactions in UCITS or AIF that are subject to supervision under the law of a Member State which requires an equivalent level of risk spreading in their assets, where the relevant person and any other person for whose account the transactions are effected are not involved in the management of that undertaking.

4. For the purposes of paragraphs 1, 2 and 3 of this Article, 'personal transaction' means a trade in a financial instrument or other asset effected by or on behalf of a relevant person, where at least one of the following criteria are met:

(a) that relevant person is acting outside the scope of the activities he carries out in that capacity;

(b) the trade is carried out for the account of any of the following persons:

(i) the relevant person;
(ii) any person with whom he has a family relationship, or with whom he has close links;
(iii) a person whose relationship with the relevant person is such that the relevant person has a direct or indirect material interest in the outcome of the trade, other than a fee or commission for the execution of the trade.

Explanatory text

19. Box 51 is based on Article 13 UCITS Level 2 and requires AIFM to establish rules for personal transactions by relevant persons that are involved in activities causing potential conflicts of interest, or that have access to inside information or to other confidential information relating to AIF or to transactions with or for AIF.

20. Unlike Article 13 UCITS Level 2 Box 8 does not only refer to personal transactions with financial instruments but also to personal transactions with other assets. ESMA believes that a misuse of confidential information may not only occur in relation to financial instruments but also in relation to other assets, e.g. partnership interests.

21. However, ESMA acknowledges that there may be assets in relation to which a misuse of confidential information is rather unlikely e.g. deposits.

Box 52

Recording of portfolio transactions

1. AIFM should make without delay for each portfolio transaction relating to AIF a record of information which is sufficient to reconstruct the details of the order and the executed transaction or of the agreement.

2. The record referred to in paragraph 1 shall include:

(a) the name or other designation of the AIF and of the person acting on account of the AIF;

(b) the asset;

(c) where relevant, the quantity;

(d) the type of the order or transaction or agreement;

(e) the price;

(f) for orders, the date and exact time of the transmission of the order and name or other designation of the person to whom the order was transmitted, or for transactions, the date and exact time of the decision to deal and execution of the transaction; for agreements date of signing and closing;

(g) where applicable, the name of the person transmitting the order or executing the transaction;

(h) where applicable, the reasons for the revocation of an order;

(i) where relevant, for executed transactions the counterparty and execution venue identification, for agreements the contracting party.

For the purpose of point (i) of the first subparagraph, an 'execution venue' shall mean a regulated market as referred to under Article 4(1)(14) of Directive 2004/39/EC, a multilateral trading facility as referred to in Article 4(1)(15) of that Directive, a systematic internaliser as referred to in Article 4(1)(7) of that Directive, or a market maker or other liquidity provider or an entity that performs a similar function in a third country to the functions performed by any of the foregoing.

Explanatory text

22. Article 18(1) of the AIFMD requires the AIFM to have procedures and arrangements which ensure that each transaction involving the AIF may be reconstructed according to its origin, the parties to it, its nature, and time and place at which it was effected. Box 52 therefore requires the AIFM to record each portfolio transaction. Paragraph 2 of Box 52 sets out the details these records should include.

23. Management companies already have to record each portfolio transaction relating to UCITS according to Article 14 UCITS Level 2. Box 52 is based on this provision taking into account the diversity of types of AIF. Some of the terms used in Article 14 UCITS Level 2 are not suitable for specific types of AIF e.g. for private equity AIFs no 'order' will be placed to purchase partnership interests but rather a sale and purchase agreement will be negotiated. Therefore, Box 52 also refers to the term 'agreement'.

Box 53

Recording of subscription and redemption orders

1. AIFM should take all reasonable steps to ensure that the received AIF subscription and, where

relevant, redemption orders are recorded without undue delay after receipt of any such order.

2. That record should include information on the following:

(a) the relevant AIF;

(b) the person giving or transmitting the order;

(c) the person receiving the order;

(d) the date and time of the order;

(e) the terms and means of payment;

(f) the type of the order;

(g) the date of execution of the order;

(h) the number of units or shares or equivalent amounts subscribed or redeemed;

(i) the subscription or, where relevant, redemption price for each unit or shares or, where relevant, the amount of capital committed and paid;

(j) the total subscription or redemption value of the units or shares;

(k) the gross value of the order including charges for subscription or net amount after charges for redemption.

Information under point (a) to (h) should be recorded without undue delay after receipt whereas information under point (i) to (k) should be recorded as soon as available.

Explanatory text

24. In line with the UCITS approach (Article 15 UCITS Level 2) Box 53 requires AIFM to ensure that AIF subscription and, where relevant, redemption orders are recorded. The provisions are based on the relevant UCITS provisions (Article 15 UCITS Level 2) taking into account the diversity of types of AIF. Some of the terms used in the UCITS provisions are not suitable for specific types of AIF e.g. for private equity AIF there is no subscription price for each unit but rather a commitment to invest. Therefore, the term 'amount of capital committed and paid' was included.

Box 54

Recordkeeping requirements

1. AIFM should ensure that all required records referred to in Box 9 (portfolio transactions) and Box 10 (subscription and redemption orders) are retained for a period of at least five years unless the relevant national law provides for a longer retention period.

However, competent authorities may require AIFM to ensure that any or all of those records are retained for a longer period, determined by the nature of the asset or portfolio transaction, where it is necessary to enable the authority to exercise its supervisory functions under the AIFM-Directive.

2. Following the termination of the authorisation of an AIFM, Member States or competent authorities may require the AIFM to ensure that records referred to in paragraph 1 are retained for the outstanding term of the five-year period or the longer period required by relevant national law respectively.

Where the AIFM transfers its responsibilities in relation to the AIF to another AIFM, Member States or competent authorities may require that arrangements are made that such records are accessible to that AIFM.

3. The records shall be retained in a medium that allows the storage of information in a way accessible for future reference by the competent authority, and in such a form and manner that the following conditions are met:

(a) the competent authority must be able to access them readily and to reconstitute each key stage of the processing of each portfolio transaction;

(b) it must be possible for any corrections or other amendments, and the contents of the records prior to such corrections or amendments, to be easily ascertained;

(c) it must not be possible for the records to be otherwise manipulated or altered.

Explanatory text

25. In line with the UCITS (Article 16 UCITS Level 2) and MiFID (Article 51 MiFID Level 2) approach, 54 requires AIFM to ensure the retention of records of portfolio transactions and of subscription and, where relevant, redemption orders. The AIFM should retain those records for a period of at least five years unless the relevant national law provides for a longer retention period. The recordkeeping requirements apply to all types of AIF irrespective whether they are open-ended or closed-ended AIF. Where the AIFM transfers its responsibilities in relation to the AIF to another AIFM, i.e. in case another AIFM is appointed, Member States or competent authorities may require that records referred to in paragraph 1 are accessible to that AIFM.

Complaints handling

26. Since the AIFMD regulates the marketing to professional investors and not to retail investors, an AIFM should not be required to establish and implement procedures for the reasonable handling of complaints received from investors. This approach is in line with the MiFID regime according to which investment firms only have to establish such procedures for complaints received from retail clients (Article 10 MiFID Level 2).

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

IV.VIII. Possible Implementing Measures on Valuation

Extract from the Commission mandate

1. *The criteria concerning the procedures for the proper valuation of the assets and the calculation of the net asset value per share or unit to be used by competent authorities in assessing whether an AIFM complies with its obligations under Article 19(1) and Article 19(3).*

   CESR is invited to consider how these procedures should be differentiated to reflect the diverse characteristics of the assets in which an AIF may invest.

2. *The type of specific professional guarantees an external valuer should be required to provide so as to allow the AIFM to fulfil its obligation under Article 19(5).*

   CESR is asked to consider the impact of the required guarantees on the availability of external valuers to the AIFM industry.

3. *The frequency of valuation carried out by open-ended funds that can be considered appropriate to the assets held by the fund and its issuance and redemption frequency.*

   In particular, CESR is invited to consider how the appropriate frequency of valuation should be assessed for funds investing in different types of assets and with different issuance and redemption frequencies, taking into account different (and varying) degrees of market liquidity. CESR is invited to take account of the fact that such valuations shall in any case be performed at least once a year.

Introduction

1. ESMA is requested to advise the Commission on criteria for the proper valuation of assets and the calculation of the net asset value. Furthermore, ESMA is requested to advise on the type of specific professional guarantees an external valuer should be required to provide. Third, ESMA is requested to advise on the frequency of valuation carried out by open-ended funds.

2. The respondents to the call for evidence emphasized that no generally applicable procedures for the valuation of assets or for the calculation of the net asset value are in existence in the EU. In practice the valuation and net asset value calculation procedures followed by AIF are usually set out in the prospectus or equivalent offering document, or occasionally in their constitutional documents, and not in legislation. Some respondents further underlined the importance that any measures should recognize existing regulatory and industry standards, among them the IOSCO principles for hedge fund valuation in 2007.

3. With regard to the type of specific professional guarantees respondents highlighted that the key objective of the professional guarantees should be to ensure that the valuer has the appropriate expertise to carry out the valuation function according to the types of assets invested in by the AIF. In respect of the frequency of valuation respondents emphasized that ESMA should abstain from defining specific valuation cycles but rather, to develop general criteria for assessment of appropriate frequency of valuation by AIF. Respondents suggested that NAV calculation frequency should be closely correlated with the issuance and redemption policy of an AIF.

4. ESMA recognises the different existing valuation standards, taking into account different rules in different jurisdictions and the diversity of assets invested in by AIFs. ESMA seeks to identify general principles that should guide the AIFM in developing and implementing policies and procedures for a proper and independent valuation of the assets of the AIF. Due to their general character these requirements can be adapted to the specific characteristics of diverse types of assets in which an AIF may invest. ESMA took into account the IOSCO principles for the valuation of hedge fund portfolios as well as 'Regulatory Approaches to the Valuation and Pricing of Collective Investment Schemes,' Report by the Technical Committee of IOSCO (May 1999) (the '1999 Valuation Paper'). ESMA also considered the ongoing work of ESMA on developing valuation principles for UCITS as well as the ongoing work of the IOSCO Technical Committee Standing Committee on Investment Management (SC5) on updating the '1999 Valuation Paper'.

5. With regard to the calculation of the net asset value, ESMA took into account that the rules applicable to the calculation of the net asset value are subject to the national law of the country where the AIF has its registered office or in the AIF rules or instruments of incorporation. Furthermore, ESMA seeks to set out some general principles on the calculation of the net asset value.

6. A statement on the professional guarantees has to be provided in written form. It should include evidence of the valuer's qualification and capability to perform the valuation function in respect to the assets he is appointed to value.

7. As a general rule it is considered that the valuation of assets that are financial instruments has to take place every time the net asset value is calculated. However, the valuation of assets that are not financial instruments has to take place at least once a year.

Box 55

Policies and procedures for the valuation of the assets of the AIF

1. AIFM should ensure that, for each AIF it manages, written policies and procedures are established, maintained and reviewed which seek to ensure a sound, transparent and appropriately documented valuation process. Without prejudice to requirements under national law, AIFM should ensure that fair, appropriate and transparent valuation methodologies are applied for the AIF they manage in accordance AIF rules and instruments of incorporation.

2. The policies shall identify and the procedures shall reflect the valuation methodologies that will be used for each of the types of assets in which the AIF may invest according to applicable national law, the AIF rules and the instruments of incorporation. The valuation methodology in respect of the specific type of asset has to be identified prior to investment in that type of asset.

3. The policies should set out the obligations, role and duties of all parties involved in the valuation process, including the senior management. The procedures should reflect the organisational structure as set out in the policies.

4. Where an external valuer is appointed, the policies and procedures should set out a process for the exchange of information between the AIFM and the external valuer to ensure that all necessary information required for the purpose of performing the valuation task are provided.

5. Where the valuation function is performed by the AIFM itself, the policies must include a

description of the safeguards for functionally independent performance of the valuation task in accordance with Article 19 (4) b) of the AIFM Directive. Such safeguards should include measures to prevent or limit any person from exercising inappropriate influence over the way in which a person carries out valuation activities.

Explanatory Text

8. The AIFM should ensure that, for each AIF that it manages, appropriate and consistent procedures are established so that a proper and independent valuation of the assets can be performed. In order to ensure compliance with their obligation of proper valuation the AIFM has to establish and maintain sound, transparent and appropriate documented valuation procedures. This rule applies to all AIFM. The valuation procedures have to be transparent to each person to whom it may concern. This could be the regulator as well as the auditor.

9. Since the AIFM regularly employs different methodologies for valuing assets, it is important to require the AIFM to determine the valuation methodologies that will be used for each of the types of assets in which the AIF may invest. The values of the individual assets and liabilities can be determined by different methodologies and can be taken from different sources. The values of the different assets and liabilities can be determined by reference to observable prices in an active market taken or by an estimate using other valuation methodologies according to national law, the AIF rules or instruments of incorporation. For example, the valuation could be based on a market price, on a model used to value assets or another valuation methodology.

10. The price provider is not considered to be an external valuer pursuant to Article 19 AIFMD. Therefore he is not subject to the requirements for the external valuer as set out in Article 19 AIFMD, especially with regard to Article 19 (5) of the AIFMD.

11. Due to the different assets an AIF may invest in, it may be difficult for an AIFM/AIF to find a valuer capable of properly valuing all portfolio assets. Hence, an AIFM may have different external valuers for one AIF to ensure a proper valuation of all assets. The external valuer may be appointed by either the AIFM, for instance where the AIF is constituted under the law of contract and has no own legal personality, or by the AIF where the legal form of the AIF permits an internal management.

12. The description of the obligations, role and responsibilities includes all parties performing the valuation function. This will also include the external valuer.

13. Paragraph 5 and 6 contain some special requirements for the policies depending if the valuation of assets is performed by an external valuer or by the AIFM itself. If an external valuer is appointed to perform the valuation of assets a process for the exchange of information between AIFM and external valuer is crucial for the performance of the valuation of assets. This requirement is to be met in addition to the requirements set out in Article 20 (1) and (2) of the AIFMD and in the delegated acts pursuant to Article 20 (7) of the AIFMD. Article 19 (4) of the AIFMD stipulates some organizational requirements to ensure the functional independence of the process for valuation of assets. An independent performance of the valuation of assets requires safeguards which need to be specified in the policies and procedures.

Box 56

Models used to value assets

1. If a model is used to value the assets, the model and its main features should be explained in the valuation policies and procedures. The reason for the choice of the model, the underlying data and assumptions used in the model and the rationale for using it should be appropriately documented.

2. AIFM should ensure before using the model that the model is validated by a person with sufficient expertise who has not been involved in the building process of the model. The model should be subject to approval by the senior management. The validation process should be appropriately documented.

Explanatory Text

14. If a model is used to value the assets information on the main features should be given in the valuation policies and procedures. This box sets out some criteria which should be documented. Before the model is used to value the assets the model should be subject to a validation process conducted by a person which was not involved in the building process of the model. A person is qualified to conduct a validation process in respect of the model used to value the assets, if he has an adequate competence and experience in the valuation of assets by model. An auditor may also be a person with sufficient expertise.

Box 57

Consistent application of the valuation methodologies

1. The AIFM should ensure that the policies and procedures and the designated methodologies are applied consistently.

2. The principle of consistency requires that the policies and procedures and the designated methodologies should be applied to all assets within an AIF taking into account the investment strategy, the type of assets and, if applicable, the existence of different external valuers. The policies and procedures shall be applied across all AIF having the same AIFM, taking into account investment strategies, the type of assets, time zones and, if applicable, the existence of different external valuers. Unless circumstances arise suggesting an update is required, the policies and procedures shall be applied consistent over time and valuation sources and rules shall remain consistent over time.

Explanatory Text

15. An AIFM shall select and apply the valuation methodologies consistently for all assets within an AIF and across all AIF having the same AIFM. The consistent application of the policies and procedures should take account of the AIF's investment strategy and the types of assets held by the AIF. Since an AIF could have different external valuers, the principle of consistency should also take into account the existence of different external valuers.

Box 58

Periodic review of the appropriateness of the policies and procedures including the valuation methodologies

1. The policies should allow for a review of the policies and procedures, including the valuation

methodologies, periodically. The review should be carried out at least annually and prior to the engagement of the AIF with a new investment strategy or a new type of asset that is not covered by the actual valuation policy.

2. The policies should outline how a change to the valuation policy, including a methodology can be effected and in what circumstances this is appropriate. Recommendations for changes to the policies shall be made to the senior management which should review and approve any changes.

3. The Risk Management Function referred to in Box 25 should review and, if needed, provide appropriate support concerning the policies and procedures adopted for the valuation of assets.

Explanatory text

16. The desirability of consistent application over time of the policies and procedures should be balanced with a periodic review of, and appropriate changes to, the policies and procedures. This box recognizes that the AIF operates within a dynamic environment in which the investment strategies may change over time. At least annually a review of the policies and procedures including the valuation methodologies should be carried out. In addition the policies and procedures should be reviewed prior to the AIFs engagement with a new investment strategy or a new type of asset to determine whether the existing policies and procedures sufficiently address the new types of strategies and investments. However, the change of the valuation policy should follow a process predetermined in the policies and procedures.

Box 59

Review of individual values

1. The AIFM should ensure that the values of all assets held by the AIF are fair and appropriate. The AIFM has to document his assessment of the appropriateness and fairness of the individual values. The AIFM must be able to demonstrate that the AIF portfolios have been properly valued.

2. The policies and procedures should set out a review process for the individual value of assets, where applicable to the type of asset, if the material risk of an inappropriate valuation exists. The policies and procedures should describe the review process including sufficient and appropriate checks on the reasonableness of such values.

3. The valuation policies and procedures should include appropriate escalation measures to address differences on the valuation of assets.

Explanatory Text

17. In respect of all assets of the AIF the appropriateness of the individual value of the asset should be checked. The AIFM has to ensure that the assets have been properly valued. This would mean that the assets have been valued in line with the valuation policies and procedures.

18. Paragraph 2 sets out additional requirements an AIFM has to comply with when investing on behalf of the AIF in specific types of assets. For some assets, especially complex and illiquid financial instruments exists a higher risk of inappropriate valuation. It is recognized that the experience and expertise to value complex and illiquid financial instruments may rest with a limited number of individuals. In these situations it may be more difficult or not possible to find an independent pricing service or source with sufficient expertise to provide pricing for such financial instruments to which the valuation of the

asset could refer. For example, the counterparty of a derivative contract is often utilized as the primary or sole pricing provider of the instrument. Sourcing prices from such a provider may, however, present a conflict of interest for the price provider, as the price it furnishes may be influenced by its expectation of trading the instrument with the client or in the market place. If the valuation of an asset refers only to such a price the valuation of the asset may be inappropriate. The risk of inappropriate valuation could happen at least in the following cases:

(a) Valuation based on prices only available from a single counterparty or broker source;

(b) Valuation based on illiquid exchange prices;

(c) Valuations influenced by parties related to the AIFM; or

(d) Valuations influenced by other entities that may have a financial interest in the fund's performance.

19. Sufficient controls to ensure that an appropriate degree of objectivity is brought to bear in considering values that are obtained from external sources, such as counterparties or potential counterparties. Such checks may include:

(a) Verifying values by a comparison amongst counterparty sourced pricings and over time;

(b) validating values by comparison of realized prices against recent carrying values;

(c) consideration of the reputation, consistency and quality of the valuation source; or

(d) comparison with values generated by a third party.

Box 60

Calculation of net asset value per unit or share

1. The AIFM should ensure that the net asset value is calculated on the occasion of each issue or subscription of units or shares but at least once a year.

2. The AIFM should ensure that the procedures and the methodology for calculating the net asset value per unit or share is fully documented. The documentation and its application should be subject to regular verification by the AIFM.

3. The AIFM should ensure that remediate procedures are in place in the event of an incorrect calculation of the net asset value.

4. The AIFM should ensure that the number of units or shares in issue is subject to regular verification at least as often as the unit or share price is calculated.

Explanatory Text

20. The calculation of the net asset value of the AIF or the net asset value per unit or share is subject to national law and/or the fund rules pursuant to Article 19 paragraph 1 of the Directive. Therefore the advice contains only proposals on the procedure for the calculation but not on the methodology of the calculation. In paragraph 2 the obligation of the AIFM to ensure full documentation of procedures and

methodology for calculating the net asset value per unit or share is set out. Documentation and its application are subject to regular verification under the responsibility of the AIFM in order to check the calculation of the net asset value is performed correct; the intervals for regular verification may depend on the investment strategy and the assets in which the AIFM may invest. The AIFM has also to ensure remediate procedures are in place in the event of an incorrect calculation of the net asset value; the content of these procedures depends on the regulation under national law.

21. The duty to calculate the net asset value per unit or share is linked to subscriptions or redemptions taking place. This link is made in order to ensure investor and AIF receiving the correct equivalent for their money respectively the units or shares.

22. The AIFM, in addition to performing portfolio management and/or risk management, may also carry out administration functions for the AIF as set out in Annex I, this includes the calculation of the net asset value. Alternatively a third party can be appointed to perform the administration functions including the calculation of the net asset value.

23. The AIFM is always responsible for the policies and procedures for the valuation of the assets, the calculation of the net asset value and where appropriate the appointment of an external valuer in accordance with Article 19 of the Directive.

24. A third party which carries out the calculation of the net asset value for an AIF is not considered to be an external valuer for the purposes of Article 19 of the Directive, so long as this entity does not provide valuations for individual assets but incorporates values which are obtained from the AIFM, pricing sources or the external valuer(s) into the calculation process.

3. Types of professional guarantees

Box 61

Professional guarantees

1. Professional guarantees to be furnished by the external valuer have to be written documents signed by the valuer or its legal representatives.

2. The professional guarantees should contain the evidence of the external valuer's qualification and capability to perform the valuation; this includes evidence of

    a) sufficient personnel and technical resources

    b) adequate procedures safeguarding proper and independent valuation and

    c) adequate knowledge and understanding

    in respect to the investment strategy of the AIF and the assets the external valuer is appointed to value.

3. In case the external valuer is authorised to carry out valuation services by the competent authority of the state where it is established, the professional guarantee should contain the name of this authority including the relevant contact information.

Explanatory Text:

25. The professional guarantees as described in the advice are meant for giving evidence of the external valuers qualification and capability to perform the valuation. In order to perform this function, the external valuer has to provide sufficient personnel and technical resources, adequate procedures for a proper and independent valuation as well as adequate knowledge and understanding to perform the valuation. As procedures for an independent valuation are required by Article 19 paragraph 1 of the Directive, the procedures of the external valuer have to contain measures for determining and mitigating conflicts of interests between the AIFM and/or within the external valuer. The external valuers resources and procedures as well as his knowledge and understanding of assets have to correspond with the investment strategy of the AIF and the assets to be valued by him. If the external valuer is to be appointed to value only parts of the AIF's portfolio, for example assets that are real estate, he is required to supply resources, procedures, knowledge and understanding which are sufficient in respect to these assets. In case he is to value the complete AIF he has to furnish professional guarantees to demonstrate his qualification and capability in respect to all assets in which the AIF may invest. As the valuation of the assets is crucial for managing alternative investments, the prescribed guarantees shall be given in writing and be signed by the valuer or its legal representatives.

4. Frequency of valuation carried out by open-ended funds

Box 62

Frequency of valuation carried out by open-ended funds

1. The valuation of assets that are financial instruments has to take place every time the net asset value per unit or share has to be calculated pursuant to Box 60 paragraph 1.

2. The valuation of other assets has to take place at least once a year, unless there is evidence that the last determined value is no longer fair and/or proper.

Explanatory Text

26. The calculation of the net asset value per unit or share has to be carried out on the occasion of each subscription or redemption of unit or shares, at least once a year. In order to receive a realistic net asset value per unit or share - and therefore realistic creation and redemption prices - the calculation of the net asset value per unit or share has to be based on the actual value of the assets held by the AIF. The proposed advice takes into account, that there are differences in the valuation procedures with respect to the types of assets held by the AIF. There are valuation procedures that can be performed on a daily basis like the valuation of financial instruments, but there are also procedures that cannot be done with the same frequency as subscriptions and redemptions take place, for instance the assessment of real estate.

IV.IX. Possible Implementing Measures on Delegation

Extract from the Commission mandate

1. *CESR is invited to advise the Commission on the content of rules that are necessary and proportionate to ensure that an AIFM fulfills the conditions under Article 20(1).*

2. *In particular, CESR is invited to advise the Commission on the following, which are applicable both to cases of delegation and sub-delegation.*

   a) *The criteria that competent authorities should use to assess whether the reasons supplied to justify the entire delegation structure of an AIFM are objective*
   b) *The circumstances under which a delegate should be considered to have sufficient resources to perform the tasks delegated to it by an AIFM; and to be of sufficiently good repute and sufficiently experienced to perform these tasks.*
   c) *The types of institutions that should be considered to be authorized or registered for the purpose of asset management and subject to supervision. CESR is invited to consider whether to employ general criteria or to specify categories of eligible institution in this context.*
   d) *In the event of a delegation of portfolio or risk management to an undertaking in a third country, how cooperation between the home MS of the AIFM and the supervisory authority of the undertaking should be ensured*
   e) *The circumstances under which a delegation would prevent the effective supervision of the AIFM, or the AIFM from acting, or the AIF from being managed, in the best interest of its investors.*

3. *CESR is invited to advise the Commission on the content of rules that are necessary and proportionate to ensure that an AIFM fulfils the conditions under Article 20(4) and (5).*

4. *In particular, CESR is invited to advise on:*

   a) *the type of evidence necessary for an AIFM to demonstrate that it has consented to a sub-delegation*
   b) *the criteria to be taken into account when considering whether a sub-delegation would result in a material conflict of interest with the AIFM or the investors of the AIF; and for ensuring that portfolio and risk management functions have been appropriately segregated from any conflicting tasks; and that potential conflicts are properly identified, managed, monitored and disclosed to the investors of the AIF*
   c) *the form and content the notification under Article 20(5)(b) should take in order to ensure that the supervisory authorities have been properly notified*

5. *CESR is also invited to advise the Commission, in relation to Article 20(3), on the conditions under which the AIFM would be considered to have delegated its functions to the extent that it had become a letter-box entity and could no longer be considered to be the manager of the AIF.*

Introduction

1. ESMA is invited to advise the Commission on the content of rules that are necessary and proportionate to ensure that an AIFM fulfils the conditions under Article 20(1) and (2).

2. As detailed feedback to questions raised on Article 20 of the AIFMD in the call for evidence will be provided in Annex V of this paper, feedback in the following is set out only in a summarized form and only to some of the questions raised in relation to delegation.

   In the call for evidence ESMA particularly raised questions on:

   a) the criteria that competent authorities should use to assess whether the reasons supplied to justify the entire delegation structure of an AIFM are objective,
   b) the circumstances under which a delegate should be considered to have sufficient resources to perform the tasks delegated to it by an AIFM; and to be of sufficiently good repute and sufficiently experienced to perform these tasks, and
   c) the conditions under which the AIFM would be considered to have delegated its functions to the extent that it had become a letter-box entity and could no longer be considered to be the manager of the AIF.

3. Most of the respondents to the call for evidence expressed the view that it would be difficult to define an exhaustive list of criteria used for the assessment of the delegation's rationale. Some of them rather suggested seeking a flexible approach and providing categories of criteria than an exhaustive list. Others took the view that an indicative list of criteria would be helpful.

4. With regard to the circumstances under which a delegate should be considered to have sufficient resources, to be of sufficiently good repute and sufficiently experienced respondents suggested that these criteria should be deemed as satisfied by the authorization or registration of such entity.

5. As for the conditions under which the AIFM would be considered as a letter-box entity the majority of respondents took the view that an AIFM that no longer has the ability to supervise the delegated activities and to manage the risk associated with the delegation should be considered as letter box entity. One respondent pointed out that also an AIFM that is no longer capable of taking strategic decisions in relation to the management of the AIFM should be considered as letter box entity.

6. With regard to the criteria for objective reasons, the advice sets out two options for consultation. The first takes a flexible approach according to which a delegation can be justified where the AIFM can demonstrate that the delegation is done for the purpose of a more efficient conduct of the AIFM's management of the AIF. This approach is more closely aligned with the requirement in the UCITS Directive that refers to the delegation purpose 'of a more efficient conduct of the companies' business'. The second option sets out an indicative, non-exhaustive list of criteria to be used when making the assessment.

7. Furthermore, ESMA takes the view that only the criterion 'sufficiently good repute' can be assumed as satisfied by the facts that the delegate is established in the EU and is authorized or registered for the delegated tasks and the criterion has been reviewed by the competent supervisory authority within the authorization procedure. In all other cases the AIFM has to evaluate whether the delegate complies

with the criteria 'sufficient resources, sufficiently good repute and sufficient experience'. The advice contains some guidance for this evaluation.

8. As for the 'letter-box entity' it is ESMA's position that there are two situations under which an AIFM should be considered as a letter-box entity. Firstly, when the AIFM is no longer able to effectively supervise the delegated tasks and to manage the risks associated with the delegation. Secondly, when the AIFM no longer has the power to take decisions in key areas that fall under the responsibility of the senior management or to perform senior management functions.

Box 63

Delegation

1. The AIFM must comply with the provisions of Article 20 of the AIFMD prior to a third party performing a task which would otherwise be undertaken by the AIFM and which is critical or important for the proper performance of the functions it provides to an AIF.

2. A function or task shall be regarded as critical or important if a defect or failure in its performance would materially impair the continuing compliance of the AIFM with the conditions and obligations of its authorisation or its other obligations under the AIFMD, or its financial performance or the soundness or continuity of the functions it performs.

3. Without prejudice to the status of any other function or task the following functions shall not be considered as critical or important for the purposes of paragraph 1 and 2 ;

(a) the provision to the firm of advisory services, and other services which do not form part of the functions which the AIFM may additionally provide in the course of the collective management of an AIF, including the provision of legal advice to the AIFM, the training of personnel of the AIFM, billing services and the security of the firm's premises and personnel;

(b) the purchase of standardised services, including market information services and the provision of price feeds.

Explanatory text

9. There may be several tasks that need to be undertaken by AIFM in performance of a function. The AIFM must perform at least investment management functions referred to in Annex I (1)(a) or (b) of but may also provide the functions listed at Annex I (2). It is not proportionate to require the AIFM to comply with requirements in Article 20 for each and every small task that is undertaken by a third party.

10. Recital 22 states that the delegation of other 'supporting tasks' should not be subject to the specific limitations and requirements set forth in this directive. It is important to be clear as to what 'supporting tasks' may mean and in this regard it may be appropriate to draw from the MiFID where it uses the term 'critical and important'. It may be appropriate to conclude that if a task is not critical or important it is by default a supporting task.

11. It is difficult to set a list of types of tasks which will be critical or important for the proper performance of the AIFM functions. However, it is possible to categorise the following common arrangements or activities as unlikely to constitute delegation or, if they do constitute delegation, as unlikely to constitute delegation of critical and important functions:

    (a) Participation in securities settlement systems and payment systems;
    (b) Provision of one-off, expert assistance with compliance, internal audit, accounting or risk management issues;
    (c) Provision of logistical support, e.g. cleaning, catering and procurement of basic services/products;
    (d) Provision of human resources support, e.g. sourcing of temporary employees and processing of payroll;
    (e) Buying standard software 'off-the-shelf'; and

(f) Reliance on software providers for ad-hoc operational assistance in relation to off-the-shelf systems.

Box 64

General principles

1. Where an AIFM delegates to third parties the task of carrying out on its behalf one or more of its functions, the AIFM should comply, in particular, with all of the following conditions:

   (a) the delegation should not result in the delegation of senior management's responsibility;

   (b) the obligations of the AIFM towards its investors under the AIFMD should not be altered due to the delegation;

   (c) the conditions with which the AIFM must comply in order to be authorized in accordance with the AIFMD, and to remain so, should not be undermined;

   (d) the AIFM should ensure that the delegate carries out the delegated functions effectively and in compliance with applicable laws and regulatory requirements and must establish methods for reviewing the services provided by each delegate on an ongoing basis. The AIFM should take appropriate action if it appears that the delegate may not be carrying out the functions effectively or not in compliance with applicable laws and regulatory requirements;

   (e) the AIFM should retain the necessary expertise and resources to supervise the delegated tasks effectively and manage the risks associated with the delegation. The AIFM should also ensure that the delegate properly supervises the carrying out of the delegated functions, and adequately manages the risks associated with the delegation

   (f) the AIFM should ensure that continuity and quality of the delegated tasks are guaranteed also in case of a termination of delegation by either transferring the delegated tasks to another third party or incorporating it into the AIFM;

   (g) the respective rights and obligations of the AIFM and the delegate should be clearly allocated and set out in a written agreement. In particular, the AIFM must contractually ensure its instruction and termination rights. The agreement should make sure that sub-delegation could take place only with the AIFM's consent;

   (h) whenever the portfolio management is delegated, the delegation must be in accordance with the investment policy of the AIF. The delegate should be instructed by the AIFM how to implement the investment policy and the AIFM should monitor whether the delegate complies with it on an ongoing basis.

2. The AIFM should in particular take the necessary steps to ensure that the following conditions are satisfied:

   (a) the delegate must disclose to the AIFM any development that may have a material impact

on its ability to carry out the delegated functions effectively and in compliance with applicable laws and regulatory requirements;

(b) the delegate must protect any confidential information relating to the AIFM the AIF affected by the delegation and the investors of these AIF;

(c) the delegate must establish, implement and maintain a contingency plan for disaster recovery and periodic testing of backup facilities while taking into account the types of delegated functions.

Explanatory text

12. In line with the MiFID approach (Article 14 MiFID Level 2) Box 64 sets out the general principles an AIFM should comply with when delegating tasks to third parties according to Article 20 of the AIFMD.

13. In particular, the principle of senior management's sole responsibility should not be affected due to the delegation nor should the obligations of the AIFM towards its investors under the AIFMD be altered. The senior management remains fully responsible for the delegated tasks. The AIFM has to ensure that the delegated tasks continue to meet the performance and quality standards that would apply if the tasks were carried out by the AIFM itself.

14. The conditions with which the AIFM must comply in order to be authorized in accordance with the AIFMD, and to remain so, should not be undermined due to the delegation. For instance, the delegation should not undermine the condition that the senior management is of sufficiently good repute and is sufficiently experienced.

15. The AIFM should ensure that delegates perform the delegated tasks effectively and comply with applicable laws and regulatory requirements. The AIFM should monitor this compliance on an ongoing basis.

16. The AIFM should supervise the delegated tasks effectively and manage the risks associated with the delegation. For this purpose the AIFM should ensure contractually that the delegate grants it the right of information, inspection, admittance and access as well as instruction and monitoring rights. An effective monitoring of the delegated tasks also includes that the AIFM is able to terminate the delegation agreement if necessary. Therefore, the delegation agreement should provide for flexible termination rights for the AIFM.

17. Moreover, the AIFM should take necessary steps to ensure that delegates comply with certain conditions, e.g. the protection of any confidential information relating to the AIFM, the AIF affected by the delegation and their investors or the establishment and maintenance of a contingency plan for disaster recovery.

Box 65

Objective Reasons

Option 1

The AIFM must be able to justify its entire delegation structure with objective reasons; to comply with this the AIFM should be able to demonstrate that the delegation is done for the purpose of a more efficient conduct of the AIFM's management of the AIF.

Option 2

Objective reasons for delegating tasks include but are not limited to:

- optimising of business functions and processes;
- cost saving;
- expertise of the delegate in administration/ specific markets/ investments;
- access of the delegate to global trading capabilities.

Explanatory text

18. Article 20(1)(a) AIFMD states that the AIFM must be able to justify its entire delegation structure on objective reasons.

19. According to Option 1 this condition is fulfilled if the AIFM is able to demonstrate that the delegation is for the purpose of a more efficient conduct of the AIFM's management of the AIF.

20. Option 1 is based on the UCITS approach (Article 13 of the UCITS Directive) according to which management companies may delegate tasks 'for the purpose of a more efficient conduct of the companies' business'. ESMA considered the UCITS approach as a basis, because many AIFM are already authorized as management companies and because a consistent approach with the UCITS Directive avoids the application of different delegation requirements for an AIFM when it on the one hand manages UCITS, and AIF on the other hand.

21. Examples of objective reasons for a more efficient conduct of the AIFM's management of the AIF are cost saving, expertise of the delegate in administration or in specific markets/ investments or access of the delegate to global trading capabilities.

22. ESMA also recalls that according to Article 20 (1)(e) of the AIFMD the delegation must not prevent the AIFM from acting, or the AIF from being managed in the best interests of its investors. ESMA believes that a delegation that is for the purpose of a more efficient management of the AIF presents overall benefits – either immediate or long-term - for the AIF and its investors. An AIFM that delegates for the purpose of a more efficient conduct of the management of the AIF therefore meets the requirement of Article 20(1)(e) of the AIFMD as the delegation does not prevent the AIFM from acting in the best interests of the investors.

23. Option 2 provides a non-exhaustive list of objective reasons for delegating tasks instead of providing a high-level principle.

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

Box 66

Sufficient resources and experience and sufficiently good repute of the delegate

1. The AIFM has to evaluate if the delegate has sufficient resources to perform the delegated tasks and if the persons who effectively conduct the business of the delegate are sufficiently experienced and of sufficiently good repute.

2. The delegate should be considered to have sufficient resources if it employs sufficient personnel with the skill, knowledge and expertise necessary for the discharge of the tasks delegated to it and the appropriate organizational structure for the delegated tasks.

3. The persons who effectively conduct the business of the delegate should be considered to have sufficient experience if they have appropriate theoretical knowledge and appropriate practical experience in the relevant functions.

4. The persons who effectively conduct the business of the delegate should be considered to have sufficiently good repute if there are at least no negative records relevant both for the assessment of a good repute and for the proper performance of the delegated tasks. Such negative records include relevant criminal offences, judicial proceedings or administrative sanctions.

Explanatory text

24. According to Article 20(1)(b) of the AIFMD 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. The AIFM is responsible for evaluating that the delegate complies with these criteria.

25. In particular, the AIFM has to evaluate if the delegate employs personnel with the skill, knowledge and expertise necessary for the discharge of the tasks delegated to it. The delegate also has to retain the necessary organizational structure for performing the delegated tasks effectively.

26. For the evaluation if the persons who effectively conduct the business of the delegate have theoretical knowledge and practical experience in the delegated functions the AIFM should consider their professional training and the nature of their function performed in the past.

27. The persons who effectively conduct the business of the delegate should be of sufficiently good repute if there are no negative records relevant for the assessment of the good repute, e.g. relevant criminal offences, relevant judicial proceedings or relevant administrative sanctions. The negative records must also be relevant for the proper performance of the delegated tasks since the good repute cannot be assessed without considering the activities that the delegate will carry out on behalf of the AIFM

28. In order to make sure that there are no negative records special attention should be given to any offences regarding financial activities (including obligations on money laundering), dishonesty, fraud or financial crime, bankruptcy or insolvency. Furthermore, the AIFM should take into account the delegate's conduct of business in the past.

29. If the delegate is established in the EU and authorized for the purpose of the delegated tasks and if the criterion 'good repute' of the delegate has been reviewed by the relevant supervisory authority within the authorization procedure, this criterion should be assumed as satisfied unless evident facts speak against it.

Box 67

Types of institution that should be considered to be authorised or registered for asset management and subject to supervision

(1) – Management companies authorized under the UCITS Directive,

- investment firms authorised under the MiFID Directive to perform portfolio management,

- credit institutions authorised under the Directive 2006/48/EC having the authorisation to perform portfolio management under MiFID, and

- externally-appointed AIFM authorised under the AIFM Directive

should be assumed as authorised for the purpose of asset management and subject to supervision.

Explanatory text

30. Article 20(1)(c) of the AIFM Directive states that where the delegation concerns the portfolio management or 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.

31. ESMA is invited to advise the Commission on the types of institutions that should be considered to be authorized or registered for the purpose of asset management and subject to supervision. ESMA is asked to consider whether to employ general criteria or to specify categories of eligible institutions in this context.

32. This advice takes a combined approach. Paragraph 1 specifies categories of eligible institutions that should be considered to be authorized or registered for the purpose of asset management and subject to supervisions. These are management companies authorized under the UCITS Directive, investment firms authorized under the MiFID Directive to perform portfolio management, credit institutions authorized under the Directive 2006/48/EC having the authorization to perform portfolio management under MiFID, and externally appointed AIFM authorized under the AIFMD.

33. Investment companies authorized under the UCITS Directive are not listed in paragraph 1 because they are not allowed to engage in activities other than collective portfolio management (Article 28 UCITS Directive). If an AIFM delegates portfolio management to an investment company such a company engages in activities other than collective portfolio management.

34. For the same reasons internally managed AIF are not listed in paragraph 1. According to Article 6(3) of the AIFMD no internally managed AIF shall engage in activities other than the internal management of that AIF in accordance with Annex I of the AIFMD. If an AIFM delegates portfolio management to an internally managed AIF, the AIF engages in activities other than the internal management of this AIF.

35. As explained in the Introduction and Background section, ESMA is working on issues related to third countries and will bring forward proposals for consultation later in the year.

Box 68

A delegation would prevent the effective supervision of the AIFM, or the AIFM from acting, or the AIF from being managed, in the best interest of its investors in particular under the following circumstances:

1. A delegation would prevent the effective supervision of the AIFM where the AIFM does not take the necessary steps to ensure that the following conditions are satisfied:

   (a) the AIFM, its auditors and the relevant competent authorities must have effective access to data related to the delegated functions, as well as to the business premises of the delegate; and the competent authorities must be able to exercise those rights of access;

   (b) the delegate must cooperate with the competent authorities of the AIFM in connection with the delegated functions.

   (c) the AIFM makes available on request to the competent authority all information necessary to enable the authority to supervise the compliance of the performance of the delegated functions with the requirements of Article 20 of the AIFMD.

2. A delegation would prevent the AIFM from acting, or the AIF from being managed, in the best interests of its investors where the interests of the delegate may conflict with those of the AIFM or the investors of the AIF unless the potential conflicts of interest are properly identified, managed and monitored.

Explanatory text:

36. Box 68, paragraph 1 sets out particular circumstances under which a delegation would prevent the effective supervision of the AIFM. These circumstances are based on MiFID Level 2 provisions (Article 14(2)(h), (i) and (5)).

37. Paragraph 2 describes the situation under which a delegation would prevent the AIFM from acting, or the AIF from being managed, in the best interest of its investors.

Box 69

Sub-delegation – General principles

The conditions set out in Boxes 63-68 should apply mutatis mutandis where the delegate sub-delegates any of its functions to a sub-delegate.

Box 70

Type of evidence necessary for an AIFM to demonstrate its consent to sub-delegation

AIFM should demonstrate its consent to each sub-delegation in writing.

Explanatory text

38. According to Article 20(4) of the AIFMD the delegate may sub-delegate any of the functions delegated to it as long as certain conditions are fulfilled. One of the conditions is that the AIFM consented prior to the sub-delegation.

39. ESMA advises that the AIFM should demonstrate its consent to each sub-delegation in writing; 'general consent' given in advance by the AIFM to each sub-delegation does not suffice.

Box 71

Criteria to be taken into account when considering whether a delegation/ sub-delegation would result in a material conflict of interest with the AIFM or the investors of the AIF; and for ensuring that portfolio or risk management tasks haven been functionally and hierarchically separated from any other potentially conflicting tasks within the delegate/ sub-delegate; and that potential conflicts of interest are properly identified, managed, monitored an disclosed to the investors of the AIF

1. Criteria whether a delegation/ sub-delegation would result in a material conflict of interest with the AIFM or the investors of the AIF:

   (a) Where the AIFM and the sub-delegate are members of the same group or have any other contractual relationship, it should be taken into account the extent to which the sub-delegate controls the AIFM or has the ability to influence its actions;

   (b) Where the AIFM is aware that the sub-delegate and an investor of the relevant AIF are members of the same group or have any other contractual relationship, it should be considered the extent to which this investor controls the sub-delegate or has the ability to influence its actions.

2. The portfolio or risk management tasks should be considered as functionally and hierarchical separated from other potentially conflicting tasks where the following conditions are satisfied:

   (a) Those engaged in portfolio management tasks are not engaged in the performance of potentially conflicting tasks such as controlling tasks;

(b) Those engaged in risk management tasks are not engaged in the performance of potentially conflicting tasks such as operating tasks;

(c) Those engaged in risk management tasks are not supervised by those responsible for the performance of the operating tasks;

(d) The separation is ensured up to the governing body of the delegate/subdelegate.

The functional and hierarchical separation of portfolio or risk management tasks from any other potentially conflicting tasks within the delegate/ sub-delegate should be calibrated to the nature, scale and complexity of the delegate/ sub-delegate's business and to the nature and range of activities undertaken in the course of that business.

3. Criteria whether potential conflicts are properly identified, managed, monitored and disclosed to the investors of the AIF:

The delegate/ sub-delegate should take all reasonable steps to identify, manage and monitor conflicts of interest that may arise between the delegate/ sub-delegate and the AIFM or the investors of the AIF. The delegate/ sub-delegate should disclose potential conflicts of interest as well as the procedures and measures to be adopted by it in order to manage such conflicts to the AIFM which should disclose them to the investors of the relevant AIF.

Explanatory text

40. According to Article 20(2) and (5) of the AIFMD no delegation/ sub-delegation of portfolio management or risk management shall be given to (a) the depositary or to a delegate of the depositary, or (b) 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.

41. ESMA is requested to advise on the criteria to be taken into account when considering whether a sub-delegation of portfolio management or risk management would result in a material conflict of interest with the AIFM or the investors of the AIF; and for ensuring that portfolio or risk management tasks have been appropriately separated from any conflicting tasks; and that potential conflicts are properly identified, managed, monitored and disclosed to the investors of the AIF.

42. Paragraph 1 sets out criteria which should be taken into account when considering whether a delegation/ sub-delegation of portfolio management or risk management would result in a material conflict of interest with the AIFM or the investors of the AIF. These criteria are examples and therefore should not be understood as exhaustive.

43. Paragraph 2 deals with the functional and hierarchical separation of portfolio management or risk management tasks from other conflicting tasks within the delegate/ sub-delegate. Examples for tasks conflicting with portfolio management tasks are the compliance or the audit function. Examples for activities conflicting with portfolio or risk management are market making or underwriting.

44. In order to ensure proportionality ESMA considers that the functional and hierarchical separation should be calibrated to the nature, scale and complexity of the sub-delegate's business and the nature and range of activities undertaken in the course of that business.

Box 72

Form and content of notification under Article 20(4)(b) of the AIFMD

The notification should contain details of the delegate and the sub-delegate, name of the competent authority (in case the sub-delegate is authorized or registered), delegated tasks, AIF affected by the sub-delegation, copy of written consent by the AIFM and the intended effective date of the delegation.

Box 73

Letter-box entity

The AIFM would become a letter-box entity and could no longer be considered to be the manager of the AIF where:

1. the AIFM no longer retains the necessary expertise and resources to supervise the delegated tasks effectively and manage the risks associated with the delegation; or

2. the AIFM no longer has the power to take decisions in key areas which fall under the responsibility of the senior management or no longer has the power to perform senior management functions in particular in relation to implementation of the general investment policy and investment strategies.

Explanatory text

45. ESMA has identified two circumstances under which an AIFM would become a letter-box entity and could no longer be considered to be a manager of the AIF.

46. Firstly, where the AIFM is no longer able to effectively supervise the delegated tasks and to manage the risks associated with the delegation. This might be the case where the AIFM only retains few resources to supervise the delegated tasks in proportion to the extent to which it has delegated tasks and these resources are not sufficient for an effective supervision of the delegated tasks.

47. Secondly, where the AIFM no longer has the power (i) to take decisions in key areas which fall under the responsibility of the senior management or (ii) to perform senior management functions. Senior management functions include, for example, the implementation of the general investment policy and investment strategies. Further senior management functions or key areas which fall under the responsibility of the senior management are listed in Box 48.

V. Depositaries

1. Article 21 of the AIFMD sets out an extensive set of requirements on the depositaries of AIFs. In line with the implementing measures foreseen in that article, the draft advice in this area covers the following elements:

   i. Appointment of the depositary

   ii. The depositary's duties

   iii. The depositary's liability regime

   Appointment of a depositary

2. In line with the request from the Commission, the draft advice on this point sets out ESMA's proposals on the content of the contract evidencing the appointment of the depositary, which must at least regulate the flow of information necessary to enable the depositary to perform its functions. The particulars required in the contract to be signed between the depositary and the management company in the UCITS Directive were taken as a starting point with a view to ensuring consistency across the industry.

3. Due to the very diverse nature of the entities subject to the Directive, it has not been considered appropriate to develop a model agreement. This is also in line with the approach taken in CESR's advice on the UCITS IV Directive in relation to depositaries.

   Duties of the depositary

4. The depositary has two primary functions: to safekeep the AIF's assets and to oversee its compliance with the AIF's rules and instruments of incorporation and with applicable law and regulation. The Directive further assigns the depositary with a requirement to ensure the AIF's cash flows are properly monitored.

   Safekeeping

5. The duty to safekeep consists either of custody or of record keeping, depending on the type of asset. In line with the Commission's request, the draft advice addresses the types of financial instrument which should be included in the scope of the depositary's custody functions and the conditions upon which the depositary can fulfil its obligation to safekeep the assets. The 'other assets' subject to the record-keeping obligation are then defined as all assets not covered by custody. The advice sets out a number of different options in this area, each of which has potentially different consequences for the scope of the custody duty.

   Oversight function

6. The AIFMD contains the same provisions regarding the depositary's oversight functions as those set out in the UCITS Directive. However, in light of the differences in interpretation of the five oversight duties of a depositary across Member States, the draft advice aims to clarify each task.

   Cash monitoring

7. The draft advice considers the depositary's cash monitoring function as a general requirement to have a full overview of all cash movements of the AIF which should be read alongside its oversight duties. The advice acknowledges that an AIF may have cash accounts at various entities outside the depositary; as such, the aim is to have a strong requirement on the AIFM to ensure the depositary has access to all information related to each cash account opened at a third party.

8. The draft advice sets out two options regarding the tasks which would be expected of a depositary when implementing its cash monitoring obligations. One option would be to consider the depositary 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. The second option identified would require the depositary to ensure there are procedures in place to appropriately monitor the AIF's cash flows and that they are effectively implemented and periodically reviewed. In particular, the depositary would be required to look into the reconciliation procedure and monitor that remedial action is taken without undue delay whenever a discrepancy is identified.

9. Under its cash monitoring function, the depositary is also required to ensure that payments made by investors upon subscription have been received by the AIF. ESMA has put forward advice with a view to clarifying that the depositary is not expected to interfere with the distribution channels of the AIF but simply to verify the information at the level of the AIF's register.

Due diligence duties

10. Article 21(11) of the Directive provides significant detail as to the conditions to be met for the depositary to be able to delegate any of its safekeeping functions. ESMA has been asked to provide further guidance in relation to the specific tasks the depositary would be expected to carry out in order to comply with its due diligence duties and, if possible, to provide a template of evaluation, selection, review and monitoring criteria to be considered. The advice focuses on what the depositary is expected to do when delegating custody tasks given the potentially significant implications for the AIF and its investors.

Segregation

11. The third party to which the depositary wishes to delegate custody tasks must segregate the assets belonging to the depositary's clients from its own assets and from assets of the depositary in such a way that they can at all times be clearly identified as belonging to clients of a particular depositary. The Commission has asked ESMA to clarify what the specific requirements should be to make sure the sub-custodian effectively meets that obligation. The draft advice is based on Article 16 of the MiFID implementing Directive (2006/73/EC), adapted to reflect that sub-custodians may, as the AIFMD acknowledges, use 'omnibus accounts'.

<u>Depositary liability</u>

12. The depositary's liability regime is a central issue of the AIFMD. The advice aims to strike the appropriate balance between the Directive's objective of ensuring a high level of investor protection while refraining from placing the entire responsibility on depositaries. With this objective in mind, the proposed advice attempts to provide clear definitions of what would constitute: (i) the loss of a financial instrument; (ii) an external event beyond the reasonable control of a depositary, the consequences of

which would have been unavoidable despite reasonable efforts; and (iii) the objective reason which could enable a depositary to discharge its responsibility by transferring it to a sub-custodian.

V.I. Appointment of a depositary

1. The AIFMD requires every AIFM to ensure that, for each AIF it manages, a single depositary has been appointed, appointment which must be formalised in a written contract regulating at least the flow of information necessary to enable the depositary to perform its functions. The European Commission has asked ESMA to provide guidance on the content of such a contract and to the extent possible to provide a model agreement.

2. In order to define the elements which should be required in the written agreement evidencing the appointment of the depositary, ESMA has used the particulars required in the contract to be signed between the depositary and the management company in the UCITS framework as a starting point with a view to ensure consistency across the industry. ESMA has then suggested some amendments or new provisions to take into account the specificities of AIFs.

3. For instance, the contract will need to include provisions on the depositary's liability and the conditions under which it may transfer its liability to a sub-custodian[21], on the possibility to re-use the assets it has been entrusted with, or a description of the type of assets it will have to safekeep, given that unlike for UCITS there is no harmonisation as to the type of assets in which an AIF can invest and the AIFMD covers an extremely wide spectrum of funds.

4. Precisely because the Directive regulates AIFM which manage very different types of funds, ESMA suggests not elaborating a model agreement and provides a detailed explanation of the reasons why it has not considered that an appropriate means to improve harmonisation or investor protection.

1 Contract evidencing the appointment of a depositary

Scope of the Commission's implementing powers
The Commission shall adopt by means of delegated acts, in accordance with Article 56, and subject to the conditions laid down in Articles 57 and 58, measures specifying:
(a) the particulars that need to be included in the standard agreement as referred to in paragraph 2;...'

Extract from Level 1 Directive
2. The appointment of the depositary shall be evidenced by a written contract. The contract shall, inter alia, 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.

European Commission's Request for Advice to ESMA
1. ESMA is requested to advise the Commission on the necessary particulars to be found in the standard agreement evidencing the appointment of the depositary. In its advice, ESMA should take into account the consistency with the respective requirements in the UCITS Directive.
2. ESMA is encouraged to provide the Commission, if possible, with a draft model agreement.

[21] A 'sub-custodian' should be understood as an entity to which the depositary has delegated custody tasks in accordance with the provisions of Article 21 (11) of the AIFMD.

1.1 Particulars of the contract appointing the depositary

Box 74

Particulars to be included in the written agreement evidencing the appointment of a single depositary and regulating the flow of information deemed necessary to allow the depositary to perform its functions pursuant to Article 21 (2) of the AIFMD.

The depositary on the one hand and the AIFM and / or the AIF on the other hand shall draw up a written agreement setting out the rights and obligations of the parties to the contract.

This agreement should include at least the following elements:

1. A description of the services to be provided by the depositary and the procedures to be adopted for each type of asset in which the AIF may invest and which may be entrusted to the depositary;

2. A description of the types of assets that will fall within the scope of the depositary's function which should be consistent with the information provided in the AIF rules, instruments of incorporation and offering documents, regarding the assets in which the AIF may invest;

3. A statement that the depositary's liability shall not be affected by any delegation of its custody functions unless it has discharged itself of its liability in accordance with the requirements of Article 21 (13) or (14); and where applicable, the conditions under which the AIF or the AIFM may allow the depositary to transfer its liability to a sub-custodian including the objective reasons that could support that transfer;

4. The period of validity, and the conditions for amendment and termination of the contract; and, if applicable, the procedures by which the depositary should send all relevant information to its successor;

5. The confidentiality obligations applicable to the parties in accordance with prevailing laws and regulations; these obligations should not impair the ability of Member States competent authorities to have access to the relevant documents and information;

6. The means and procedures by which the depositary will transmit to the AIFM or the AIF all relevant information that the latter needs to perform its duties including the exercise of any rights attached to assets, and in order to allow the AIFM and the AIF to have a timely and accurate situation of the accounts of the AIF. The details of such means and procedures should be described in this agreement or set out in the service level agreement or similar document;

7. The means and procedures by which the AIFM will ensure the depositary has access to all the information it needs to fulfil its duties, including the process by which the depositary will receive information from other parties appointed by the AIF or the AIFM;

8. Information regarding the possibility for the depositary or a sub-custodian to re-use the assets it was entrusted with or not and where relevant the conditions related to the potential re-use;

9. The procedures to be followed when a modification to the AIF rules, instruments of incorporation or offering documents is being considered, detailing the situations in which the depositary should be informed, or where a prior agreement from the depositary is needed to proceed with the modification;

10. All necessary information that needs to be exchanged between the AIF, the AIFM and the depositary related to the sale, subscription, redemption, issue, cancellation and re-purchase of units or shares of

the AIF;

11. Where the parties to the contract envisage appointing third parties to carry out their respective duties, an undertaking to provide, on a regular basis, details of any third parties appointed; and upon request, information on the criteria used to select the third party and the steps taken to monitor the activities carried out by the selected third party;

12. All information regarding the tasks and responsibilities in respect of obligations relating to anti-money laundering and combating the financing of terrorism;

13. Information on all cash accounts opened in the name of the AIF or in the name of the AIFM on behalf of the AIF and procedures by which the depositary will be informed prior to the effective opening of any new account opened in the name of the AIF or in the name of the AIFM on behalf of the AIF;

14. Details regarding the depositary's escalation procedure(s), including the identification of the persons to be contacted within the AIF and / or the AIFM by the depositary when it launches such a procedure.

Subject to national law, there shall be no obligation to enter into a specific written agreement for each AIF; it shall be possible for the AIFM and the depositary to enter into a framework agreement listing the AIF managed by that AIFM to which it applies.

The parties may agree to transmit part or all of this information electronically. Proper recording of such information shall be ensured.

The agreement shall include the procedures by which the depositary, in respect of its duties has the ability to enquire into the conduct of the AIFM and / or the AIF and to assess the quality of information transmitted including by way of on-site visits. It shall also include a provision regarding the possibilities and procedures for the review of the depositary by the AIFM and / or the AIF in respect of the depositary's contractual obligations.

The law applicable to the agreement shall be specified.

Explanatory text

5. The proposed advice is based on the requirements defined in Chapter V (Articles 30 to 37) of Directive 2010/43/EC implementing Directive 2009/65/EC (the UCITS Directive) as well as on the corresponding advice published by CESR (now ESMA) on that issue.

6. A majority of respondents to the call for evidence asked for consistency with existing requirements (UCITS, MiFID). Nevertheless, they acknowledged that some specificities of the AIF (e.g. the broader range of assets in which they may invest) justified tailored provisions.

7. Some respondents identified other elements they considered should be obligatory in the agreement. These included: types of assets covered, right of re-use, flow of information, termination of the contract, modification of the AIF rules, etc. Finally, respondents called for flexibility in the list of particulars to be found in the standard agreement in order to allow the parties to adapt the agreement as needed.

8. In line with the position presented by the industry in its responses to the call for evidence, ESMA considers that the tasks the depositary will need to perform to fulfil its safekeeping and oversight functions will depend on the type of assets it is entrusted with rather than on the type of fund (UCITS or non UCITS). Therefore, the existing requirements regarding the particulars to be included in the con-

tract signed between the depositary of a UCITS and its management company have served as a starting point and ESMA has then suggested additional requirements or amendments to take into account the specificities of AIFs, which may invest in similar asset classes as UCITS funds but also in many other asset classes not covered by the UCITS Directive.

9.The following items have been added:

- Firstly, the advice acknowledges that the contract can be signed by the AIF or the AIFM acting on behalf of the AIF or in some instances by both
- Eligible assets: the contract would be required to contain a description of the assets in which the AIF is allowed to invest in order for the depositary to know upon its appointment what procedures to set up to be able to appropriately safekeep all assets of the AIF as well as the procedures it might eventually have to put in place for the assets in which the AIF may invest
- Right of re-use: the contract should clarify whether the depositary is authorised or not to re-use the AIF's assets and under what conditions
- Cash accounts: the AIFM should be required to ensure the depositary is informed of all cash accounts opened at third parties in the name of the AIF or of the AIFM acting on behalf of the AIF (see relevant section of this advice)
- Escalation procedure: the contract should clarify the procedures to be followed in the event that the depositary needs to launch an escalation procedure (e.g. alert the AIFM of a material risk identified in a specific market's settlement system)

10.The following items have been amended in comparison with the UCITS requirements:

- Termination of the contract: the contract should stipulate the situations which could lead to the termination of the contract as well as details regarding the termination procedure. In light of the depositary's liability with regard to its custody functions, this provision should reflect that putting an end to its contract is the depositary's ultimate recourse when it is not satisfied the assets are correctly protected. It should also help prevent from the moral hazard whereby the AIFM would make investment decisions irrespective of custody risks on the basis that the depositary is , in most cases, liable.
- Liability: where for UCITS, a simple statement recalling that the depositary's liability is not altered by the delegation of custody duties to a third party is sufficient, the suggested drafting requires the parties to the contract to detail in the agreement the conditions under which the depositary can transfer its liability to a sub-custodian in accordance with the provisions of Article 21 (13)
- Flow of information: the AIFM would be required to ensure the depositary receives all information it needs to perform its safekeeping and oversight duties, including information to be provided directly by third parties (e.g. prime brokers, third parties where bank accounts have been opened in the name of the AIF or of the AIFM acting on behalf of the AIF, etc.)

11.With regard to the requirement to include in the contract the procedures by which the depositary can enquire into the conduct of the AIFM and verify the quality of the information provided, ESMA has considered appropriate to include the same requirement that exists under the UCITS framework as this is an essential provision which should enable the depositary to assess the AIFM's processes and procedures in order to adapt its own safekeeping and oversight procedures. Such a possibility is particularly relevant for the depositary upon its appointment.

1.2 ESMA's justification for not providing a model agreement

12. There was a consensus among the respondents to the call for evidence against the development of a model agreement on the basis that this was not required by the AIFMD and that it would restrict commercial freedom. The industry further argued that such a model could not take into account the broad range of AIFs and could create difficulties of interpretation with respect to national legal frameworks.

13. In line with the feedback received to the call for evidence, ESMA sees no need to define a model agreement. The provisions contained in the advice combined with the requirements detailed in the level one text provide a strong regulatory framework which would not be enhanced by imposing a model agreement.

14. Furthermore, it is probably not possible to define a model agreement that would be applicable to the wide range of situations that exist under the AIFMD framework in terms of the AIF legal structures, investment strategies, and considering the various ownership rights in the different jurisdictions. It seems more reasonable to leave some room for the industry actors to adapt their contracts to this broad universe provided they comply with the requirements ESMA has elaborated on the particulars which must be included in every contract between the depositary and the AIF and / or the AIFM acting on behalf of the AIF.

15. Moreover, industry actors have an interest in entering into a contract and, where the case may be, into a Service Legal Agreement which both must be thoroughly drafted as these documents set out the contractual liability of each party.

16. Lastly, it is worth stressing that ESMA had decided not to recommend developing a model agreement in the framework of the UCITS Level 2 measures.

V.II. Duties of the depositary

1. According to the AIFMD and in line with the UCITS framework, the depositary has two primary functions: to safekeep the AIF's assets and to oversee its compliance with the AIF rules and instruments of incorporation and with applicable law and regulation. The Directive further assigns the depositary with a requirement to ensure the AIF's cash flows are properly monitored.

Cash Monitoring

2. ESMA has considered the depositary's cash monitoring function as a general requirement to have a full overview of all cash movements of the AIF which should be read along with its oversight duties. ESMA has acknowledged that an AIF may have cash accounts at various entities outside the depositary and therefore defined a pre-requisite for the AIFM to ensure the depositary has access to all information related to each cash account opened at a third party.

3. Further ESMA is consulting on two options to specify the tasks which would be expected of a depositary when implementing its cash monitoring obligations. One option would be to consider the depositary 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. The second option contemplated would require the depositary to ensure there are procedures in place to appropriately monitor the AIF's cash flows and that they are effectively implemented and periodically reviewed. The depositary would in particular be required to look into the reconciliation procedure and monitor that remedial action is taken without undue delay whenever a discrepancy is identified.

4. Under its cash monitoring function, the depositary is also required to ensure that payments made by investors upon their subscription have been received by the AIF. ESMA acknowledges the need for clarification in relation to the scope of such a requirement and has therefore put forward an advice with a view to clarifying that the depositary is not expected to interfere with the distribution channels of the AIF but simply to verify the information at the level of the AIF's register.

5. Lastly, the depositary is responsible to ensure the AIF's cash is properly booked which ESMA takes to mean that cash accounts have only been opened with entities authorised under Article 18 (1) (a) to (c) of MiFID or any bank or credit institution in the non EU countries where the AIF has had to open an account in relation to an investment decision.

Safekeeping

6. The depositary is responsible for safekeeping the AIF's assets. Depending on the type of assets, they are to be either held in custody – as is the case for financial instruments which can be registered in a financial instruments account or can be physically delivered to the depositary in line with Article 21 (8) (a) - or in record keeping. ESMA has been asked to provide advice on the type of financial instruments which should be included in the scope of the depositary's custody functions and on the conditions upon which the depositary can fulfil its obligation to safekeep the assets.

7. ESMA has suggested setting out a clear definition of the financial instruments to be held in custody and adopting an *a contrario* approach to define the 'other assets' as referred to in Article 21 (8) (b) which

shall be subject to record keeping. Such a definition is a key element of the implementing measures regarding Article 21 since it conditions the scope of the depositary's custody functions and consequently the scope of its liability. Therefore ESMA is consulting on various options to seek industry input on the workability of the definition elaborated and its potential consequences.

8. As a first step of the definition, there is a consensus within ESMA to define financial instruments as transferable securities, money market instruments and units of collective investment undertakings in reference to the first items of Annex 1, Section C of Directive 2004/39/EC. Further ESMA considers that should be held in custody those financial instruments that the depositary is in a position to instruct the transfer of. Two options are put forward to translate that. One would be to consider that all financial instruments registered or held directly or indirectly in the name of the depositary should be in custody. The second considers that custody should be limited to financial instruments with respect to which the depositary can instruct the transfer of title by means of a book entry on a register maintained by a settlement system as defined in Directive 98/26/EC or a similar non European securities settlement system. The last component of the definition concerns financial instruments provided as collateral. ESMA is consulting on three different options regarding collateral.

9. As to what is specifically expected of a depositary to comply with its custody function, ESMA considers the depositary should ensure the financial instruments are properly segregated in its books and where relevant in those of its sub-custodians, are subject to due care and protection and should assess and monitor relevant custody risks.

10. With regard to the depositary's record keeping function which applies to all other assets (i.e. which do not comply with the definition of financial instruments to be held in custody), the AIFMD imposes two obligations on the depositary. The first one is to verify the ownership of the AIF / AIFM of such assets and the second is to maintain a record of those assets for which it is satisfied the AIF / AIFM holds the ownership. ESMA recommends clarifying that maintaining a record could mean registering the assets in its name in the first instance or where the assets are registered in the name of the AIF or in the name of the AIFM acting on behalf of the AIF, to ensure it is able at any time to provide a comprehensive and up to date inventory of all the AIF's assets. To enable the depositary to meet that requirement, ESMA has specifically imposed an obligation on the AIFM to ensure the depositary has access to all relevant information it needs including from third parties (e.g., administrators, prime brokers, etc.) to ensure it can fulfil its obligations. ESMA is consulting on two options to reflect the means by which the depositary can ensure it is able to provide such an inventory. It can either rely on information provided to it by the AIF / AIFM or third parties on a timely basis or it can mirror every transaction in a position keeping system.

Oversight function

11. The AIFMD contains the same provisions regarding the depositary's oversight functions as those required under the UCITS Directive. However, in light of the major differences in interpretation of the five oversight duties of a depositary across Member States, ESMA has decided to provide a draft advice which suggests clarifications on each task.

12. Furthermore ESMA recommends defining general principles applicable to the depositary's oversight function. ESMA suggests for example that the depositary should assess, upon its appointment, the risks associated with the nature scale and complexity of the AIF and set up appropriate procedures. It also

recommends that it should perform ex post verifications of procedures which are under the responsibility of the AIF, the AIFM or a third party. ESMA suggests that, when appointed as a third party to perform duties it has to oversee as AIF's depositary, the depositary must manage potential conflicts of interest as required by Article 21 (10). The proposed advice finally sets out a general requirement for the depositary to set up and implement an escalation procedure for all instances where it detects a potential irregularity while conducting its oversight procedures.

Due diligence duties

13. Article 21 (11) provides significant detail as to the conditions to be met for the depositary to be able to delegate any of its safekeeping functions. ESMA has been asked to provide further guidance in relation to the specific tasks the depositary would be expected to carry out in order to comply with its due diligence duties and if possible to provide a template of evaluation, selection, review and monitoring criteria to be considered.

14. ESMA suggests focusing mainly on the tasks to be implemented when delegating custody since that is where the implications can be material for the AIF and its investors. In its proposed advice, ESMA has highlighted the main steps the depositary should go through when appointing a sub-custodian and during its ongoing monitoring. The requirements have been based on the best market practices and with a view to ensuring the depositary takes into consideration all elements relevant to the consequences of the insolvency of the sub-custodian. ESMA has also assumed that, in light of its liability, the depositary would have a sufficiently strong incentive to take all appropriate measures to ensure the financial instruments will be subject to a high level of protection and care.

Segregation

15. One of the conditions the third party to which the depositary wishes to delegate custody tasks to must comply with on an ongoing basis is the requirement to segregate the assets belonging to the depositary's clients from its own assets and from assets of the depositary in such a way that they can at all times be clearly identified as belonging to clients of a particular depositary. The Commission has asked ESMA to clarify what the specific requirements should be to make sure the sub-custodian effectively meets that obligation.

16. ESMA has based its advice on Article 16 of Directive 2006/73/EC and has adapted the text to reflect that this requirement is to be met by sub-custodians for which the Directive acknowledges they can use 'omnibus accounts'. It has also been refined to address the specific concern this requirement is supposed to mitigate i.e. the consequences of the insolvency of the sub-custodian.

V.III. Depositary functions

1 Depositary functions pursuant to §7 – Cash monitoring

Scope of the Commission's implementing powers
The Commission shall adopt by means of delegated acts, in accordance with Article 56, and subject to the conditions laid down in Articles 57 and 58, measures specifying:
[…]
(c) the conditions for performing the depositary functions pursuant to paragraphs 7, 8 and 9

Extract from Level 1 Directive
'7. The depositary shall in general ensure that the AIF's cash flows are properly monitored, and shall in particular ensure that all payments made by or on behalf of investors upon the subscription of shares or units of an AIF have been received and that all cash of the AIF has been booked in one or more cash accounts opened in the name of the AIF or in the name of the AIFM acting on behalf of the AIF or in the name of the depositary acting on behalf of the AIF at an entity referred to in Article 18 (1) (a) to (c) 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, or an other entity of the same nature as the entity referred to in Article 18 (1) (a) to (c) of that Commission Directive 2006/73/EC in the relevant market where cash accounts are required provided that such entity is subject to effective prudential regulation and supervision of the same effect as the provisions laid down in European Union law and which are effectively being enforced, and in accordance with the principles set forth in Article 16 of Commission Directive 2006/73/EC
Where the cash accounts are opened in the name of the depositary acting on behalf of the AIF, no cash of the entity referred to in the first subparagraph and none of the depositary's own cash shall be booked on such accounts.'

European Commission's Request for Advice to ESMA

1. ESMA is requested to advise the Commission on the conditions for performing the depositary functions pursuant to Article 21(7). ESMA is requested to specify conditions for the depositary to ensure that:
   - the AIF's cash flows are properly monitored;
   - all payments made by or on behalf of investors upon the subscription of shares or units of - an AIF have been received and booked in one or more cash accounts opened in the name of the AIF or in the name of the AIFM acting on behalf of the AIF or in the name of the depositary acting on behalf of the AIF at an entity referred to in Article 18 (1) (a) to (c) of Commission Directive 2006/73/EC in accordance with the principles set forth in Article 16 of Commission Directive 2006/73/EC.
   - where cash accounts are opened in the name of the depositary acting on behalf of the AIF, none of the depositary's own cash is kept in the same accounts.

   In its advice, ESMA should take into account the legal structure of the AIF and in particular whether the AIF is of the closed-ended or open-ended type.

2. ESMA is requested to advise the Commission on the conditions applicable in order to assess whether:
   - an entity can be considered to be of the same nature as the entity referred to in Article 18 (1) (a) to (c) of Commission Directive 2006/73/EC, in the relevant non-EU market where opening cash accounts on behalf of the AIF are required;
   - such an entity is subject to effective prudential regulation and supervision to the same effect as the provisions laid down in European Union law and which is effectively enforced.

3. ESMA is requested to advise the Commission on the conditions applicable in order to determine what shall be considered as the relevant market where cash accounts are required.

1.1 Cash flow monitoring

Box 75

Cash Monitoring – general information requirements

The AIFM should ensure the depositary is provided, upon commencement of its duties and on an ongoing basis, with all relevant information it needs to comply with its obligations pursuant to Article 21 (7) including by third parties and particularly that:

- the depositary is informed, upon its appointment, of all existing cash accounts opened in the name of the AIF, or in the name of the AIFM acting on behalf of the AIF;
- the depositary is informed prior to the effective opening of any new cash account by the AIF or the AIFM acting on behalf of the AIF;
- the depositary is provided with all information related to the cash accounts opened at a third party entity, directly from those third parties in order for the depositary to have access to all information regarding the AIF's cash accounts and have a clear overview of all the AIF's cash flows.

Where the depositary does not receive this information, the AIFM will have been deemed not to have satisfied the requirements of Article 21of the directive.

Explanatory text

1. ESMA believes that as a prerequisite, the AIFM should be required to ensure the depositary has access to all information it needs to effectively perform its functions pursuant to Article 21 (7) of the Directive.

2. Such information can be provided directly by the AIF or the AIFM or by any other entity appointed by the AIF / AIFM to perform tasks relevant to the depositary's function (e.g. prime brokers, third party banks, administrators, etc.)

3. The suggested advice particularly takes into account the different situations which can occur under the AIFMD with regard to cash accounts and their impact on the depositary's ability to properly monitor the AIF's cash flows:

   - when the account is opened in the depositary's books, it has complete knowledge of all inflows and outflows;
   - when the account is opened at a third party in the name of the depositary, it also has knowledge of all inflows and outflows and there can be no transfer without its knowledge and consent;
   - when the account is opened at a third party in the name of the AIF or in the name of the AIFM on behalf of the AIF, the depositary has to rely on the information provided by the AIFM or the third party upon request of the AIFM to monitor the cash flows.

4. It is ESMA's understanding that the depositary should have a clear overview of all cash inflows and outflows in all instances. The proposed advice therefore specifically requires the AIFM to ensure the depositary receives timely and accurate information including from any third party where the cash account is opened in order to have access to all information related to all cash flows.

Box 76

Proper monitoring of all AIF's cash flows

Option 1

The depositary should act as a central hub to ensure an effective and proper monitoring of all cash movements and in particular, it should:

1. ensure the cash belonging to the AIF is booked in an account opened at the depositary; or

2. where cash accounts are opened at a third party entity:

(a) ensure those accounts are only opened with entities referred to in Article 18 (1) (a) to (c) of Directive 2006/73/EC or another entity of the same nature in the relevant market where cash accounts are required as defined in §2 of Box 77 (Ensuring the AIF's cash is properly booked)

(b) mirror the transactions of those cash accounts into a position keeping system and make periodic reconciliations between the cash accounts statements and the information stemming from the AIF's accounting records

(c) ensure the AIFM has taken appropriate measures to send all instructions simultaneously to the third party and the depositary

Option 2

To ensure the AIF's cash flows are properly monitored, the depositary should at least:

1. ensure that cash accounts opened at a third party are only opened with entities referred to in Article 18 (1) (a) to (c) of Directive 2006/73/EC or another entity of the same nature in the relevant market where cash accounts are required as defined in §2 of Box 77 (Ensuring the AIF's cash is properly booked);

2. ensure there are proper procedures to reconcile all cash flow movements and verify that they are performed at an appropriate interval;

3. ensure appropriate procedures are implemented to identify on a timely basis significant cash flows and in particular those which could be inconsistent with the AIF's operations;

4. review periodically the adequacy of those procedures including through a full review of the reconciliation process at least once a year;

5. monitor on an ongoing basis the outcomes and actions taken as a result of those procedures and alert the AIFM if an anomaly has not been rectified without undue delay.

Explanatory text

5. A majority of respondents to the call for evidence felt that the depositary should only be required to check that adequate processes and procedures are in place, taking into account reports received from service providers. Several respondents underlined that additional steps should not be added to the

investment process and thereby introduce potential delays (such as signing off on every cash movement).

6. Respondents to the call for evidence also sought clarification that the monitoring of cash flows by the depositary should not be interpreted as requiring the insertion of an additional account with the depositary through which all cash flows must pass.

7. ESMA is consulting on two options to define the conditions for the depositary to ensure that the AIF's cash flows are properly monitored.

8. Under Option 1, 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. To enable the depositary to achieve that objective, option 1 includes a requirement for the instructions related to the third party cash accounts to be sent simultaneously (from the AIFM or the third party entity) to the depositary. As a consequence, the depositary could intervene immediately if it considers the cash flows inappropriate. However, this does not mean that the depositary would take part in the management of the fund. The investment decisions remain in the sole hands of the AIFM. Frequency of the reconciliations under §2 (b) should be proportionate to the nature, scale and complexity of the AIF.

9. Under Option 2, 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 where the cash accounts are opened at 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 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; and

- 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.

1.2 ESMA's justification for not providing further guidance in relation to the depositary's duties regarding subscriptions in the AIF

10. In its request, the Commission has asked ESMA to provide advice on the conditions for the depositary to ensure all payments made by or on behalf of investors upon the subscription of shares or units of - an AIF have been received and booked in one or more cash accounts opened in the name of the AIF or in the name of the AIFM acting on behalf of the AIF or in the name of the depositary acting on behalf of the AIF at an entity referred to in Article 18 (1) (a) to (c) of Commission Directive 2006/73/EC in accordance with the principles set forth in Article 16 of Commission Directive 2006/73/EC.

11. ESMA has reflected on the scope of the depositary's duties in this context and decided to draft its advice on the basis that the depositary is not required to make verifications along the distribution channel but rather to put the focus on the entity which centralises the subscriptions (e.g., a transfer agent) and limit the depositary's verifications to the information stemming from the AIF's register.

12. There are in fact two questions in the Commission's request. One is to define conditions to specify how the depositary can ensure the payments made by investors upon the subscription have been received. The second question relates to the depositary's duty to ensure the cash received is properly booked.

13. ESMA considers that it answers the second question in the relevant section below which deals with the conditions applicable to ensure the cash is booked in appropriate accounts. ESMA has taken a more conservative approach than the one adopted in the European Commission's request by assuming the requirements to ensure the cash belonging to the AIF is correctly booked in one or more accounts opened in the name of the AIF, or of the AIFM or of the depositary is not limited to the subscription proceeds but applies to all cash belonging to the AIF.

14. With regard to the first question, ESMA has not put forward a specific requirement here as it considers the requirements set forth in the section which deals with the depositary's oversight duties already cover this issue. The only alternative to the suggested approach would be to require the subscription proceeds to be booked directly in an account at the depositary. This is because the depositary is not necessarily aware of each and every potential distribution channel through which investors may subscribe in the AIF. Therefore, the only way for the depositary to be sure that 'all payments upon subscription have been received', would be to require all subscriptions to be directly booked in its books. Such an option would significantly limit the choice of distribution channels and promote direct subscription orders only. Moreover, ESMA does not consider this alternative as improving investor protection as it would encourage investors to contract directly with the AIF, thereby missing out on potential benefits from alternative advisory channels.

15. Nevertheless, the depositary's duty 'to ensure that the payments made by investors upon the subscription have been received' is important in ensuring that the AIF only issues shares when the corresponding subscriptions have been processed.

16. In accordance with the proposed advice (see section on oversight duties, Box 82), the depositary would be required to:

- ensure there is an appropriate reconciliation performed between the subscription orders in the AIF's register and the subscription proceeds received;

- ensure there is an appropriate reconciliation performed between the number of units / shares issued and the subscription proceeds received; and
- check (regularly) the consistency between the total number of units / shares in the AIF's accounting records and the total number of outstanding units / shares in the AIF's register.

1.3 Conditions for ensuring the AIF's cash is properly booked

Box 77

Ensuring the AIF's cash is properly booked

The depositary should be required to:

1. ensure that the AIFM complies on an ongoing basis with the requirements of Article 16 of Directive 2006/73/EC in relation to cash and in particular where cash accounts are opened at a third party entity in the name of the depositary acting on behalf of the AIF, take the necessary steps to ensure the AIF's 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

2. ensure the AIF's cash is booked in one or more cash accounts opened at an entity referred to in Article 18 (1) (a) to (c) of Directive 2006/73/EC or at a bank or a credit institution of the non EU country in which the AIFM / AIF has been compelled to open a cash account in relation to an investment decision

Explanatory text

17. As mentioned earlier, the level one requirements for the depositary to ensure that all the AIF's cash has been booked in proper accounts can be read in two different ways: in this consultation paper, a conservative approach was adopted by considering that this obligation should apply to all the AIF's cash whereas in its request the Commission has linked that requirement with the provision regarding subscriptions.

18. As a reminder, Article 18 (1) (a) to (c) of Commission Directive 2006/73/EC states that: 'Member States shall require investment firms, on receiving any client funds, promptly to place those funds into one or more accounts opened with any of the following:

    - a central bank
    - a credit institution authorised in accordance with Directive 2000/12/EC
    - a bank authorised in a third country'

19. Respondents to the call for evidence considered that any entity established in the relevant 3rd country should be considered 'of the same nature' as those entities referred to in Article 18 (1)(b) of Commission Directive 2006/73/EC if it is a credit institution subject to prudential regulation and supervision to the same effect as the provisions laid down in EU law. This includes central banks and any bank authorized in a third country. They also stressed that it should not be necessary to have a cash account for each jurisdiction in which a transaction is carried out.

20. Many respondents stressed the importance of segregating cash belonging to AIFs from the depositary's own cash. Nevertheless, some requested the possibility for the AIFM to open one cash account into which subscriptions monies received in respect of several AIFs may be paid.

Q25: How difficult would it be to comply with a requirement by which the general operating account and the subscription / redemption account would have to be opened at the depositary? Would that be feasible?

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

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

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

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

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

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

2 Depositary functions pursuant to §8 – Safe-keeping duties

Scope of the Commission's implementing powers

The Commission shall adopt by means of delegated acts, in accordance with Article 56, and subject to the conditions laid down in Articles 57 and 58, measures specifying:

[…]

(c) the conditions for performing the depositary functions pursuant to paragraphs 7, 8 and 9, including:

- *the type of financial instruments that shall be included in the scope of the depositary's custody duties according to point (a) of paragraph 8;*
- *the conditions upon which the depositary may exercise its custody duties over financial instruments registered with a central depositary;*
- *and the conditions upon which the depositary shall safe keep according to point (b) of paragraph 8 the financial instruments issued in a nominative form and registered with an issuer or a registrar;*

Extract from Level 1 Directive

8. '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.'

European Commission's Request for Advice to ESMA

1. ESMA is requested to advise the Commission on:
   - the type of financial instruments that shall be included in the scope of the depositary's custody duties as referred to in point (a) of Article 21(8), namely (i) the financial instruments that can be registered in a financial instruments account opened in the name of the AIF in the depositary's books, and (ii) the financial instruments that can be 'physically' delivered to the depositary;
   - the conditions applicable to the depositary when exercising its safekeeping custody duties for such financial instruments, taking into account the specificities of the various types of financial instruments and where applicable their registration with a central depositary, including but not limited to:
   - the conditions upon which such financial instruments shall be registered in a financial instruments accounts opened in the depositary's books opened in the name of the AIF or, as the case may be, the AIFM acting on behalf of the AIF,;
   - the conditions upon which such financial instruments shall be deemed (i) to be appropriately segregated in accordance with the principles set forth in Article 16 of Commission Directive 2006/73/EC), and (ii) to be clearly identified at all times as belonging to the AIF, in accordance with the applicable law; and what shall be considered as the applicable law.

a. ESMA is requested to advise the Commission on:
   - the type of 'other assets' with respect to which the depositary shall exercise its safekeeping duties pursuant to paragraph 8(b), namely all assets that cannot or are not to be kept in custody by the depositary pursuant paragraph to Article 8(a);
   - the conditions applicable to the depositary when exercising its safekeeping duties over such 'other assets', taking into account the specificities of the various types of asset, including but not limited to financial instruments issued in a 'nominative' form, financial instruments registered with an issuer or a registrar, other financial instruments and other types of assets.

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

c. In its advice, ESMA should also consider the circumstances where assets belonging to the AIF, are subject to temporary lending or repurchase arrangements or any type of arrangements under which financial instruments may be re-used or provided as collateral by the AIF or AIFM on behalf of the AIF, whether or not such arrangements involve transfer of legal title to the financial instruments, and advise on the conditions applicable to the depositary to perform its safekeeping duties accordingly.

2.1 Definition of the financial instruments that should be held in custody

Box 78

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

Pursuant to Article 21 (8) (a), financial instruments belonging to the AIF should be included in the scope of the depositary's custody function when they meet all the criteria defined below:

1. they are transferable securities, money market instruments or units of collective investment undertakings – as listed in Annex I, section C of Directive 2004/39/EC;

2. they are not provided as collateral in accordance with the provisions set out in Box 79; and

   Option 1

3. they are registered or held in an account directly or indirectly in the name of the depositary.

   Option 2

3. they are financial instruments with respect to which the depositary may itself or through its sub-custodian instruct the transfer of title or an interest therein by means of a book-entry on a register maintained by a settlement system as designated by Directive 98/26/EC or a similar non-European securities settlement system which acts directly for the issuer or its agent.

Additionally, financial instruments which can be physically delivered to the depositary should be held in custody.

Financial instruments that are directly registered with the issuer itself or its agent (e.g. a registrar or a transfer agent) in the name of the AIF should not be held in custody unless they can be physically delivered to the depositary. Further, financial instruments which comply with the definition set out above will remain in custody when the depositary is entitled to re-use them whether that right has been exercised or not. Where the financial instruments have been provided by the AIF or the AIFM acting on behalf of the

AIF to a third party under a temporary lending agreement, they will no longer be held in custody by the depositary and fall under the definition of 'other assets' in accordance with Article 21 (8) (b).

In the context of Option 1, where the financial instruments are registered directly with the issuer or its agent making the depositary the only registered owner on behalf of one or more unidentified clients, the financial instruments should be held in custody. However, such financial instruments should not be held in custody if the depositary is clearly identified in the register as acting on behalf of the AIF and thus the AIF is clearly identified as the owner of the financial instruments.

All financial instruments that do not comply with the above definition should be considered as 'other assets' under the meaning of the AIFMD Article 21 (8) (b) and be subject to record keeping duties.

Explanatory text

21. Respondents to the call for evidence were of the view that the list of financial instruments to be held in custody should not include by default all instruments listed in Annex 1, Section C of MiFID.

22. Respondents suggested two approaches to determine the financial instruments that should be held in custody. Some favoured a first approach consisting in a non-exhaustive list of criteria (e.g. ownership rights, dematerialisation, liquidity and the free transferability, fungibility, special obligations to the holder, interest certified on a register etc). In their view, the criteria should lead to the exclusion of OTC derivatives and interests in partnerships or funds not traded on a regulated market. The alternative approach suggested by some respondents consisted of a list of instruments. The instruments potentially eligible would be: transferable securities, units in collective investment undertakings registered with the depositary itself or the Central Security Depositary and money market instruments.

23. The issue of financial instruments held in nominative form and registered with an issuer or depositary raised some concerns. Some respondents were of the opinion that financial instruments registered with an issuer or a registrar should be subject to particular attention and not automatically fall within the scope of 'other assets'.

24. Respondents to the call for evidence supported an a contrario approach to defining 'other assets', although some stakeholders suggested including a list of such 'other assets'.

25. The proposed advice aims at providing a clear definition of the financial instruments to be held in custody and suggests adopting an a contrario approach to determine the 'other assets' subject to record keeping as referred to under Article 21 (8) (b).

26. The suggested definition of financial instruments subject to custody duties is designed to capture all financial instruments the depositary is in a position to control and if need be retrieve. ESMA is consulting on two drafting options, both of which explicitly exclude all securities that are directly registered with the issuer itself or its agent (e.g. a registrar or a transfer agent) in the name of the AIF, all assets that take the form of a financial contract (e.g. derivatives) as well as investments in privately held companies or real estate assets.

27. The first option contemplates a simple definition by which all financial instruments registered or held in an account directly or indirectly in the name of the depositary[22] through a subsidiary or a sub-custodian would be considered as instruments to be held in custody. Such a definition provides a clear framework as to the scope of custody with little room for interpretation. The liability regime defined in the directive by which the depositary would be obliged to return a financial instrument of an identical type or the corresponding amount would then clearly be linked to all assets for which only the depositary can instruct a transfer including where it is the registered owner in the issuer's register as is commonly the case with target funds. However, ESMA recommends that when the register clearly stipulates that the depositary is acting on behalf of the AIF as the ultimate owner of the financial instruments, the depositary should only be required to perform record keeping duties. In all instances, the registrar is not to be considered as a sub-custodian under the meaning of the Directive and its implementing measures.

28. The second option suggests referring to the use of settlement systems to define what financial instruments should be held in custody. If that approach were to be retained, 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 a register maintained by a settlement system as designated by Directive 98/26/EC or a similar non-European securities settlement system which acts directly for the issuer or its agent would be subject to custody. With regard to situations where the financial instruments are registered in the sole name of the depositary in the register, in order to provide an equivalent framework in terms of investor protection, the depositary would then be required under its record-keeping duties to use its best efforts to enable the AIF to exercise its rights over the financial instruments if it wishes to and at its own cost (see the requirements on record-keeping in Box 81 below).

29. In accordance with the above described definition, financial instruments which would fall under the 'other assets' category would include but not be limited to:

- physical assets that do not qualify as financial instruments or cannot be physically delivered to the depositary
- all financial contracts (e.g. derivative contracts – swaps, options, futures, etc.)
- all financial instruments, including units and shares of collective investment schemes, issued in a nominative form or registered directly with the issuer or through a registrar acting on behalf of the issuer, in the name of the AIF, provided that they cannot be physically delivered to the depositary
- all financial instruments provided as collateral under a title transfer collateral arrangement (see provisions below)
- cash deposits with a third party entity

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

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

[22] at the level of the settlement system or where relevant in the issuer's register.

Box 79

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

Financial instruments provided as collateral should not be held in custody if they are provided:

Option 1

under a title transfer financial collateral arrangement as defined in Directive 2002/47/EC on financial collateral arrangements

Option 2

under a title transfer financial collateral arrangement or under a security financial collateral arrangement by which the control over / possession of the financial instruments within the meaning of Article 2 (2) of Directive 2002/47/EC on financial collateral arrangements is transferred away from the AIF or the depositary to the collateral taker or a person acting on its behalf

Option 3

under a financial collateral arrangement as defined in Directive 2002/47/EC on financial collateral arrangements

Explanatory text

30. With regard to collateral, a majority of the respondents to the call for evidence pointed out that the depositary would no longer be liable when the assets have been disposed of either in whole or in part and as a result are no longer 'entrusted' to the depositary (through repurchase agreements or other collateral arrangements).

31. ESMA suggests taking into account the definitions of financial collateral arrangements laid out in Directive 2002/47/EC ('the Collateral directive') which distinguishes two types of collateral arrangements:

(i) title transfer financial collateral arrangements defined as arrangements, including repurchase agreements, 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

(ii) security financial collateral arrangements defined as arrangements under which a collateral provider provides financial collateral by way of security to or in favour of a collateral taker, and where the full or qualified ownership of, or full entitlement to, the financial collateral remains with the collateral provider when the security right is established

32. ESMA suggests excluding from the scope of the depositary's custody duties all financial collateral arrangements where there is a title transfer and has put forward three options regarding the treatment of security financial collateral arrangements to be submitted to the consultation. Option 1 suggests excluding only the financial instruments subject to a title transfer collateral arrangement. Option 2 suggests excluding financial instruments subject to a title transfer collateral arrangement and financial instruments subject to a security financial collateral arrangement where that arrangement includes the transfer of the instruments out of the depositary's books. Option 3 suggests excluding all financial instruments subject to a collateral arrangement whatever its form.

33. Under option 2, the depositary would be required to keep in custody collateral subject to a security financial collateral arrangement only when it is under its 'control' or in its 'possession'. In accordance with Article 2 (2) of Directive 2002/47/EC, collateral is considered as being 'provided' by a collateral provider to a collateral taker where the financial collateral is 'delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral taker or of a person acting on the collateral taker's behalf'. The collateral transferred out of the depositary's books would therefore no longer be in custody.

34. Lastly, for the avoidance of doubt, ESMA suggests clarifying that when the AIF or the AIFM has given its consent for the re-hypothecation by the depositary of financial instruments held in custody, those instruments remain in custody whether the right of re-use has been exercised or not. Further, ESMA suggests specifying that where financial instruments are subject to a repurchase agreement, they are no longer considered as belonging to the AIF and should be considered as 'other assets' as defined in Article 21 (8) (b).

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

2.2 Conditions applicable to the depositary when performing its safekeeping duties on each category of assets

Box 80

Safekeeping duties related to financial instruments that can be held in custody

1. To comply with its obligations pursuant to Article 21 (8) (a), the depositary should be required to at least:

(a) Ensure the financial instruments are properly registered in segregated accounts in order to be identified at all times as belonging to the AIF

(b) Exercise due care in relation to the financial instruments held in custody to ensure a high level of protection

(c) Assess and monitor all relevant custody risks. In particular, depositaries should be required to assess the custody risks related to settlement systems and inform the AIFM of any material risk identified.

2. Where the depositary has delegated its custody functions, the depositary would remain subject to the requirements of §1 (c) and would further have to ensure the third party (hereafter referred to as the 'sub-custodian[23]') complies with §1 (b) as well as with the segregation obligations set out in Box 16.

Explanatory text

[23] See definition in footnote 21 above

35. Given the strong liability which will be required of depositaries with regard to their custody function, ESMA believes it is sufficient to require the depositary to ensure the financial instruments are subject to due care and protection. The proposed advice also suggests the depositary should be required to assess the custody risks related to the settlement systems, Central Security Depositaries or registrars and inform the AIFM of material risks identified. The depositary should however not be responsible for any failures occurring at the CSD or in the settlement system as is clarified in the Section on liability (see provisions below) since the depositary does not select either the CSD or the settlement system which are dictated by the assets in which the AIFM decides to invest.

Box 81

Safekeeping duties related to 'other assets' – Ownership verification and record keeping

The AIFM should ensure the depositary is provided, upon commencement of its duties and on an ongoing basis, with all relevant information it needs to comply with its obligations pursuant to Article 21 (8) (b) including by third parties.

To comply with its obligations pursuant to Article 21 (8) (b), the depositary should be required to at least:

1. Ensure it has timely access to all relevant information it needs to perform its ownership verification and record keeping duties, including from third parties (e.g. prime brokers).

2. Ensure that it possesses sufficient and reliable information for it to be satisfied of the AIF's ownership right or of the ownership right of the AIFM acting on behalf of the AIF over the assets.

3. Maintain a record of those assets for which it is satisfied the AIF or the AIFM acting on behalf of the AIF holds the ownership of those assets.

   In order to comply with that obligation, the depositary should be required to:

   (a) register, on behalf of the AIF, assets in its name or in the name of its delegate; or

   (b) ensure, where assets are registered directly in the name of the AIF or the AIFM, or physically held by the AIF or the AIFM, it is able to provide at any time a comprehensive and up to date inventory of the AIF's assets.

   To that end, the depositary should:

   Option 1

   (i) ensure there are procedures in place so that assets so registered cannot be assigned, transferred, exchanged or delivered without the depositary or its delegate having been informed of such transactions; or

   (ii) have access to documentary evidence of each transaction from the relevant third party on a timely basis

   Option 2

   mirror all transactions in a position keeping record

   In the context of § (b) the AIFM should be required to ensure that the relevant third party provides the depositary with certificates or other documentary evidence every time there is a sale / acquisition or a corporate action and at least once a year.

In any event, the depositary should ensure that the AIFM has and implements appropriate procedures to verify that the assets acquired by the AIF it manages are appropriately registered in the name of the AIF or in the name of the AIFM on behalf of the AIF, and to check consistency between the positions in its records and the assets for which the depositary is satisfied the AIF or the AIFM acting on behalf of the AIF holds the ownership.

Additional requirement if Option 2 is retained in Box 78 with regard to the definition of financial instruments to be held in custody

In the context of § (a), the depositary should ensure the AIF, its investors or the AIFM acting on behalf of the AIF, are able to exercise their rights if a problem arises that affects assets for which the depositary or its delegate is the registered owner either by clearly identifying the AIF as the ultimate owner of the assets or, where the depositary or its delegate is the only registered owner of the assets on behalf of a group of one or more unidentified clients, by taking appropriate actions to ensure the AIF's ownership right is recognised by the relevant parties. Where a legal action is required, the costs related to such an action would have to be borne by the AIF, the AIFM or as the case may be the AIF investors.

4. The depositary should set up and implement an escalation process for situations where an anomaly is detected (e.g. to notify the AIFM and if the situation cannot be clarified / corrected, alert the competent authority).

Explanatory text

36. For all assets that do not fall under the definition of financial instruments to be held in custody, the depositary is first required to verify the right of ownership of the AIF or the AIFM acting on behalf of the AIF.

37. Respondents to the call for evidence asked for a flexible approach regarding the ownership verification to make sure it can apply across all relevant asset classes, having regard to the nature and type of evidence which is available to the depositary. They would appreciate that ESMA provides specific guidance in relation to certain asset classes where the depositary may have no or limited means to access evidence of title. The ultimate goal would be that the implementing measures provide depositaries with sufficient legal and operational certainty in respect of verification of ownership. Stakeholders expressed their concerns about the information, documents and evidence that would be deemed necessary to verify ownership. They believe it is an issue on which ESMA could consider developing guidelines which would include practical examples of appropriate evidence of ownership.

38. To achieve a sufficient level of comfort that the AIF is indeed the owner of the assets, ESMA suggests the depositary should make sure it receives such information which the depositary deems necessary to be satisfied the AIF holds the ownership right over the asset. That could be a copy of an official document evidencing that the AIF is the owner of the asset(s) or any formal and reliable evidence that the depositary considers appropriate. If necessary, it should request additional evidence from the AIF or AIFM or as the case may be from a third party.

39. Whenever a legal structure has been set up between the AIF and the assets in which it wishes to invest the depositary should satisfy itself that the legal structure was not set up to circumvent the provisions of Article 21 and its implementing measures.

40. The depositary is then required to maintain a record of all assets for which it is satisfied the AIF holds ownership over. Respondents to the call for evidence do not have a clear view of how to comply with the obligation to keep a record. They asked for clarifications on this requirement.

41. ESMA has defined a pragmatic approach taking into account the different types of assets with which depositaries of AIFs can be entrusted and suggests requiring the depositary to either register the assets in its own name or rely on timely information provided by third parties with a view to know at all times where the assets of the AIF are and make sure it can provide upon request a complete inventory of all the AIF's assets.

42. Depending on the type of assets, it may opt for a registration in its name (e.g. for target funds), in other instances it may simply set up a procedure to receive information from third parties (listed derivatives, collateral).

43. Point (b) is meant to provide inter alia a response to the specific requirement in the European Commission's request to ESMA to provide advice on the conditions upon which the depositary shall safekeep financial instruments issued in a nominative form and registered with an issuer or registrar where they are not held in custody. Prior information of the depositary is expected to be feasible in the case of AIF with infrequent transactions and/or transactions which are subject to pre-settlement negotiation (e.g., real estate investments). In the second indent, the proposed requirements are designed for AIF with more frequent portfolio trading, for example investments in derivatives both on and off exchange. Nevertheless, the proposed advice leaves flexibility to the depositary as to how it ensures it knows at all times where the assets are. The strong requirement for the depositary to be able at any time to provide a comprehensive and up to date inventory of all the AIF's assets should encourage depositaries to take appropriate action to monitor closely all transactions.

44. Where prime brokers have been appointed by the AIF or the AIFM, ESMA believes the reporting requirements imposed by the UK FSA could constitute a good reference point. In particular, the nature of the relationship between an AIF or AIFM and a prime broker will depend on the extent to which assets held in custody include assets subject to collateral arrangements. In this regard it is noted that prime brokers regulated by the UK FSA are subject to specific requirements introduced to address concerns arising from the insolvency of Lehman Brothers International Europe. These include requirements to:

- Include a disclosure annex within each executed prime brokerage agreement to provide a summary of the key re-hypothecation provisions (where these provisions exist) and a statement of the key risks to clients on the prime brokers insolvency;
- Provide daily reporting to clients on the status of their client assets and client money.

45. Consideration could be given to the application of these requirements to all prime broker relationships where those relationships involve re-hypothecation rights.

46. Finally, if an anomaly is detected, the depositary should be required to launch an escalation process by which it first informs the AIFM of its findings and if its concerns persist and have not been cleared by the AIFM, the depositary should alert the regulator.

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

Q36: Could you elaborate on the differences notably in terms of control by the depositary when the assets are registered directly with an issuer or a registrar (i) in the name of the AIF directly, (ii) in the name of the depositary on behalf of the AIF and (iii) in the name of the depositary on behalf of a group of unidentified clients?

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

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

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

3 Depositary functions pursuant to §9 – Oversight duties

Scope of the Commission's implementing powers

The Commission shall adopt by means of delegated acts, in accordance with Article 56, and subject to the conditions laid down in Articles 57 and 58, measures specifying:
[…]
(c) the conditions for performing the depositary functions pursuant to paragraphs 7, 8 and 9

Extract from Level 1 Directive

9. In addition to the tasks referred to in paragraph 7 and 8, the depositary shall:

- *(a) ensure that the sale, issue, re-purchase, redemption and cancellation of units or shares 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, the AIF rules or instruments of incorporation and the procedures laid down in Article 19;*
- *(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 or instruments of incorporation.*

European Commission's Request for Advice to ESMA

1. ESMA is requested to advise the Commission on the conditions the depositary must comply with in order to fulfil its duties pursuant to Article 21(9). The advice shall include all necessary elements specifying the depositary control duties when inter alia verifying the compliance of instructions of the AIFM with the applicable national law or the AIF rules or instruments of incorporation, or when ensuring 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 laid down in Article 19.

Box 82

Oversight duties – general requirements

At the time of its appointment, the depositary should assess the risks associated with the nature, scale and complexity of the AIF's strategy and the AIFM's organisation in order to define oversight procedures which are proportionate to the AIF and the assets in which it invests. Such procedures should be regularly updated.

To comply with its oversight duties, the depositary is expected to perform *ex post* controls and verifications of processes and procedures that are under the responsibility of the AIFM, the AIF or an appointed third party. The depositary should in all circumstances ensure a procedure exists, is appropriate, implemented and frequently reviewed.

The depositary is required to establish a clear and comprehensive escalation procedure to deal with situations where potential irregularities are detected in the course of its oversight duties, the details of which should be made available to the competent authorities upon request.

The AIFM should ensure the depositary is provided, upon commencement of its duties and on an ongoing basis, with all relevant information it needs to comply with its obligations pursuant to Article 21 (9)

including by third parties and particularly that the depositary is able to perform on-site visits of its own premises and any service provider appointed by the AIF or the AIFM (e.g. Administrator, external valuer) to ensure the adequacy and relevance of the procedures in place.

Explanatory text

47. Some respondents to the call for evidence underlined that the depositary's obligations pursuant to §9 should be those of oversight and checking that appropriate processes are in place rather than double-checking every single event. Some respondents would like these obligations to be limited to periodic ex-post verifications. They stressed that proper performance of these duties of the depositary was dependent on the AIFM providing up-to-date versions of the AIF rules and/or instruments of incorporation.

48. ESMA considers that, as a general principle, the depositary should set up procedures and processes which are proportionate to the estimated risks. Upon its appointment the depositary would therefore be required to make an assessment of the most significant risks to be controlled for the specific AIF taking into account various factors (e.g. the size of the AIF and of the AIFM, the type of assets, the procedures in place at the AIF / AIFM / third party, the AIF's trading frequency, etc.).

49. A second general principle behind the proposed advice is to consider that the depositary should provide second level controls. On that basis, it should be expected to perform ex post verifications of procedures that are under the responsibility of another entity which can be the AIFM, the AIF or a third party (e.g., an administrator, a prime broker, an accountant). That is the reason why the depositary should in all circumstances ensure a procedure exists within the AIFM or any other entity (e.g. an administrator, accountant), is appropriate and is implemented. It should also review this procedure or ensure that the procedure is being frequently reviewed. This framework does not prevent depositaries, where deemed appropriate, to conduct ex ante verifications to discharge their duties.

50. To comply with its obligation, the depositary should also be expected to have its own clear and comprehensive escalation procedure in the event it detects something potentially irregular in the course of its oversight duties. Such a procedure should include the notification of competent authorities of any material breach. The depositary should provide the details of its escalation procedure to the competent authorities upon request.

51. Lastly, the depositary should be able to perform on-site visits of any service provider (e.g. Administrator, external valuer) to ensure the adequacy and relevance of the procedures in place.

(a) Oversight duties related to subscriptions / redemptions

Box 83

Clarifications of the depositary's oversight duties

Duties related to subscriptions / redemptions (a)
To fulfil its duties pursuant to Article 21 (9) (a), the depositary should be required to:

1. ensure that the AIF, the AIFM or the designated entity has and implements an appropriate procedure to :

   (a) reconcile

   - the subscription / redemption orders with the subscription proceeds / redemptions paid, and
   - the number of units or shares issued / cancelled with the subscription proceeds received / redemptions paid by the AIF

   (b) verify on a regular basis that the reconciliation procedure is appropriate.

   To that end, the depositary should in particular regularly check the consistency between the total number of units or shares in the AIF's accounts and the total number of outstanding shares or units that appear in the AIF's register

2. ensure and regularly check the compliance of the procedures regarding the sale, issue, repurchase, redemption and cancellation of shares or units of the AIF with the applicable national law and the AIF rules and / or instruments of incorporation and verify that these procedures are effectively implemented.

The frequency of the depositary's checks should be proportionate to the frequency of subscription and redemptions.

Explanatory text

52. The approach suggested here is to clarify what are the appropriate verifications the depositary should be expected to carry out to ensure the sale, issue, re-purchase, redemption and cancellation of units or shares of the AIF are carried out in accordance with the applicable national law and the AIF rules or instruments of incorporation.

53. With regard to subscriptions and redemptions, ESMA believes the depositary should check the consistency between on the one hand the number of units or shares issued and on the other hand the subscription proceeds received. Moreover, in order to ensure that payments made by investors upon their subscription have been received, ESMA suggests requiring the depositary to further ensure another reconciliation is conducted between the subscription orders and the subscription proceeds. To be consistent, ESMA has also suggested that the same reconciliation be performed with regard to redemption orders. Finally, the depositary would also be required to verify that the number of units or shares in the AIF's accounts matches the number of outstanding units or shares in the AIF's register. The depositary is expected to adapt its procedures taking into account the frequency of subscriptions and redemptions. The frequency of these controls could be defined at the time of its appointment.

54. As for the sale of units or shares, ESMA has reflected on the slight difference in the wording used in Article 21 (9) (a) compared to Article 22 (3) (a) and Article 32 (3) (a) of the UCITS Directive. Where in the UCITS directive, this requirement refers explicitly to the sale, issue, re-purchase (...) on behalf of a common fund or by the management company, in the AIFM directive there is no such reference. ESMA does not consider that the deletion of that reference was intended to provide for a broader scope of the depositary's oversight functions in relation to AIFs as opposed to UCITS.

55. Therefore, ESMA has based its advice on the assumption that the depositary's first oversight duty in the UCITS Directive and the AIFMD should be considered as trying to achieve the same objective.

56. ESMA believes that the requirements should be limited to the sales of units or shares by the AIF or the AIFM for a number of reasons. First, it would not be materially possible to suggest the depositary should ensure compliance with applicable law and AIF rules regarding the sales on the secondary market for instance. If an AIF has defined in its rules that it is not to be distributed to a certain category of investors (e.g., citizens of a certain country for tax purposes for example), the depositary would be required to ensure no units / shares are sold by any unit-holder / shareholder to a such an investor. Secondly, it would seem incoherent to define a regulation that at a prohibitive cost for depositaries would provide for a more protective framework for professional investors as compared to retail investors. Lastly ESMA believes the legislator's intention was clearly to align the depositary's oversight duties for AIFs with those required for UCITS depositaries since this discrepancy in the wording is the only difference between the two sets of requirements. All other oversight duties have been reproduced in the AIFM Directive from the UCITS directive with exactly the same terms. ESMA is of the view that the only reason why there is no mention of issued 'by the AIF' in the AIFMD is because the distinction in the UCITS directive between different legal structures (common funds vs. management company) does not exist in the AIFMD.

(b) Oversight duties related to the valuation of shares or units of the AIF

Box 84

Clarifications of the depositary's oversight duties

Duties related to the valuation of shares / units (b)

1. The depositary should verify on an-going basis that appropriate and consistent procedures are established for the valuation of the assets of the AIF in compliance with the requirements of Article 19 and its implementing measures and the AIF rules and instruments of incorporation.

2. The depositary should ensure that the valuation policies and procedures are effectively implemented and periodically reviewed.

3. The depositary's procedures should be proportionate to the nature, scale and complexity of the AIF and conducted at a frequency consistent with the frequency of the AIF's valuation policy as defined in Article 19 and its implementing measures.

4. Where the depositary considers the calculation of the value of the shares or units of the AIF has not been performed in compliance with applicable law or the AIF rules or the provisions of Article 19, it should notify the AIFM and ensure timely remedial action has been taken in the best interest of the AIF's investors.

5. Where applicable, the depositary should be required to check that an external valuer has been appointed in accordance with the provisions of Article 19 of the AIFMD and its implementing measures.

Explanatory text

57. In accordance with Article 19 of the AIFMD, the AIFM is fully responsible of the valuation process. Hence, the depositary is not expected to systematically recalculate the NAV but to ensure that

appropriate procedures are in place to perform the NAV calculation and that they are effectively implemented (see relevant sections of the consultation paper).

58. To that end, the depositary should be expected to take all appropriate actions to ensure that the valuation procedures are appropriate with regard to the nature, scale and complexity of the AIF and that the valuation of shares / units provided to investors is appropriate. That could be achieved through the performance of sample checks or where relevant, by comparing the consistency of the evolution of the NAV calculation over time with that of a benchmark. When setting up its oversight procedures, the depositary should ensure it has a clear understanding of the valuation methodologies used by the AIFM or the external valuer to value the assets of the fund. The frequency of the depositary's checks should be proportionate to the frequency defined in the AIFM's valuation policy in accordance with Article 19 and its implementing measures. The depositary does not need to check the valuation every day if the NAV calculation is performed daily but it would have to define a frequency of enquiries consistent with a daily NAV calculation to be satisfied the value of the shares is calculated in accordance with applicable law and regulation and the AIF rules and instruments of incorporation.

59. If the depositary is not satisfied that the procedures are appropriate or effectively implemented, it should notify the AIFM and monitor the changes made to the valuation process to ensure corrective measures are taken in a timely manner and in the best interest of investors.

(c) Oversight duties relating to the carrying out of the AIFM's instructions

Box 85

Clarifications of the depositary's oversight duties

Duties related to the carrying out of the AIFM's instructions (c)

To fulfil its obligation pursuant to Article 21 (9) (c), the depositary should be required to:

1. Set up and implement appropriate procedures to verify the compliance of the AIF / AIFM with applicable law and regulation as well as with the AIF's rules and instruments of incorporation. In particular, the depositary should monitor compliance of the AIF with investment restrictions and leverage limits defined in the AIF's offering documents. Those procedures should be proportionate to the nature, scale and complexity of the AIF.

2. Set up and implement an escalation procedure where the AIF has breached one of the limits or restrictions referred to under §1.

Explanatory text

60. ESMA views this oversight duty as the core of the depositary's ongoing oversight duty of the AIF and the one for which there is an obvious need for clarification to reach a more harmonised framework across the Member States.

61. Read literally, Article 21(9)(c) could be interpreted as a requirement for the depositary to perform in all instances ex ante controls of instructions received from the AIFM. ESMA believes that such a requirement would not be possible to meet in most cases. The proposed advice therefore sets out a general principle the depositary would have to comply with to fulfil its duty under Article 21(9)(c),

which consists in setting up a procedure to verify on an ex-post basis in most cases the compliance of the AIF with all applicable law and regulation and the AIF rules and instruments of incorporation. The advice further requires the depositary to specifically monitor the AIF's compliance with the investment restrictions and leverage limits defined in the AIF's offering documents.

62. ESMA considers the depositary should for example check the AIF's investments are consistent with its investment strategy as described in the AIF rules and offering documents with a view to ensure it does not breach its investment restrictions, if any. The depositary should also monitor the AIF's transactions and investigate any 'unusual' transaction it has identified in conjunction with its cash monitoring duties.

63. The depositary would generally be expected to adopt an ex-post approach and where a settlement failure was identified for instance to obtain from the AIFM to reverse the transaction that was in breach at its own cost. However, the provisions laid out in the proposed advice do not prevent the depositary from adopting an ex-ante approach where it deems appropriate, e.g. for AIF which invest in less liquid assets (physical assets, real estate assets) or which initiate less frequent transactions.

(d) Oversight duties relating to the timely settlement of the transactions

Box 86

Clarifications of the depositary's oversight duties

Duties related to the timely settlement of transactions (d)

Option 1

No additional requirement

Option 2

To fulfil its obligation pursuant to Article 21(9)(d), the depositary should be required to set up a procedure to detect any situation where the consideration is not remitted to the AIF within the usual time limits, notify the AIFM and where the situation has not been remedied, request the restitution of the financial instruments from the counterparty where possible.

Where the transactions do not take place on a regulated market, the usual time limits should be assessed with regard to the conditions attached to the transactions (OTC derivative contracts, investments in real estate assets or in privately held companies)

Explanatory text

64. This requirement speaks for itself for open-ended funds which trade in liquid markets. However ESMA considers it may be worth clarifying what usual time limits means outside the scope of transactions executed on a regulated market. ESMA suggests referring to the relevant contracts by which the AIF has secured its investment.

(e) Oversight duties relating to the AIF's income distribution

Box 87

Clarifications of the depositary's oversight duties

Duties related to the AIF's income distribution (e)

To fulfil its obligation pursuant to Article 21(9)(e), the depositary should be required to:

1. Ensure the net income calculation is applied in accordance with the AIF rules, instruments of incorporation and applicable national law

2. Ensure appropriate measures are taken where the AIF's auditors have expressed reserves on the annual financial statements

3. Check the completeness and accuracy of dividend payments and where relevant of the carried interest

Explanatory text

65. The net income calculation can be performed by the AIFM itself or another entity appointed to provide that calculation. The depositary's role is to ensure the income distribution was appropriate and where it identifies an error to ensure the AIFM has taken appropriate remedial action. Once it has ensured the net income calculation was appropriate, it can verify the completeness and accuracy of the income distribution and primarily of the dividend payments.

66. Similarly, under requirement 2, the depositary is expected to monitor that where auditors have expressed reserved on the AIF's accounts, the AIFM has taken appropriate measures to provide sufficient comfort to the auditors to ensure such reserves will not be reiterated.

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

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

Q42: As regards the requirement for the depositary to ensure the sale, issue, repurchase, redemption and cancellation of shares or units of the AIF is compliant with the applicable national law and the AIF rules and / or instruments of incorporation, what is the current practice with respect to the reconciliation of subscription orders with subscription proceeds?

Q43: Regarding the requirement set out in §2 of Box 83 corresponding to Article 21 (9) (a) and the assumption that the requirement may extend beyond the sales of units or

shares by the AIF or the AIFM, how could industry practitioners meet that obligation?

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

Q45: Do you prefer option 1 or option 2 in Box 86? Please give reasons for your view.

Section 2 Due diligence duties

Scope of the Commission's implementing powers
The Commission shall adopt by means of delegated acts, in accordance with Article 56, and subject to the conditions laid down in Articles 57 and 58, measures specifying:
[…]
(d) the due diligence duties of depositaries pursuant to paragraph 11 (c);

Extract from Level 1 Directive
11. The depositary shall not delegate to third parties its functions as described in this Article, safe for those referred to in paragraph 8.
The depositary may delegate to third party the functions referred to in paragraph 8, subject to the following conditions:
[…]
(c) 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 keeps 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;

European Commission's Request for Advice to ESMA

1. ESMA is requested to advise the Commission on the duties the depositary has to carry out in exercising its due diligence duties pursuant to Article 21(11), namely:
- procedures for the selection and the appointment of any third party to whom it wants to delegate parts of its tasks; and
- procedures for the periodic review and ongoing monitoring of that third party and of the arrangements of that third party in respect of the matters delegated to it.

2. ESMA is encouraged to develop a comprehensive template of evaluation, selection, review and monitoring criteria to be considered

Box 88

Due Diligence Requirements

1. When the depositary delegates any of its safekeeping functions, it should implement an appropriate, documented and regularly reviewed due diligence process in the selection and ongoing monitoring of the delegate.

(a) When appointing a sub-custodian, the depositary should roll out a due diligence process which aims to ensure that entrusting financial instruments to a sub-custodian provides an adequate level of protection. Such a process should include at least the following steps:

(i) assess the regulatory and legal framework (including country risk, custody risk, enforceability of contractual agreements). This assessment should particularly enable the depositary to determine the potential implication of the insolvency of the sub-custodian

(ii) assess whether the sub-custodian's practice, procedures and internal controls are adequate to ensure the financial instruments will be subject to reasonable care

(iii) assess whether the sub-custodian's financial strength and renown are consistent with the delegated tasks. This assessment shall be based on information provided by the potential sub-custodian as well as third party data and information where available

(iv) ensure the sub-custodian has the operational and technological capabilities to perform the delegated custody tasks with a satisfactory degree of protection and security

(b) The depositary should perform ongoing monitoring to ensure the sub-custodian continues to comply with the criteria defined under §1 and the conditions laid out in Article 21 (11) (d), and at least:

(i) monitor the sub-custodian's performance and its compliance with the depositary's standards

(ii) ensure it exercises reasonable care, prudence and diligence in the performance of its custody tasks and particularly that it effectively segregates the financial instruments assets in line with the requirements set out in Box 16

(iii) review the custody risks associated with the decision to entrust the assets to that entity and promptly notify the AIF or AIFM of any change in these risks. This assessment should be based on information provided by the sub-custodian as well as third party data and information where available. During market turmoil or where a risk has been identified, the frequency and the scope of the review should be increased

2. The depositary should design contingency plans for each market in which it appoints a delegate to perform safekeeping duties. Such a contingency plan may include the identification of an alternative provider, if any.

3. The depositary shall terminate the contract in the best interest of the AIF and its investors where the delegate no longer complies with the requirements.

Explanatory text

1. The respondents to the call for evidence asked for consistency with other international standards and EU legislation (particularly with MiFID, Articles 14 to 17 of Directive 2006/73/EC). They provided detailed descriptions of how due diligence is performed. ESMA drew its inspiration from the best market practice.

2. The descriptions included elements to be carefully considered not only before appointing a third party but on an on-going basis as well. This list includes inter alia financial strength, market reputation, legal and operational risk, etc. Some respondents supported gathering these elements in a duly-documented procedure for selecting a sub-custodian.

3. In accordance with Article 21 (11) of the Directive, the depositary may only delegate to a third party its safe-keeping functions if it has exercised all due skill, care and diligence in the selection and the appointment of the third party to whom it wants to delegate part of its tasks and continues exercising such diligences on an ongoing basis.

4. The directive distinguishes the diligences to perform when appointing a third party and the diligences to perform on an ongoing basis as part of the monitoring process of the delegate. The proposed advice reflects that difference in §1 (a) and §1 (b) when detailing what the depositary should be required to do when it decides to delegate custody.

5. Pursuant to Article 21 (11), the depositary has to perform due diligence whenever it delegates any of its safekeeping functions whatever the type of assets, i.e. including record keeping tasks. ESMA believes that the delegation of record-keeping tasks would, in most cases, mainly concern administrative tasks.

That is why a distinction has been made with the delegation of custody tasks. Where the depositary has decided to delegate its record keeping duties, it would only be required to implement an appropriate and documented procedure to ensure the delegate complies with the requirements of Article 21 (11) (d) and more specifically that it has the structure and expertise to perform the delegated tasks.

6. With regard to the delegation of custody, ESMA considers that providing a list of due diligence tasks to perform would boil down to a box-ticking approach and would not guarantee a sufficient level of protection. Thus, it has put forward a series of principles that have to be achieved during the selection and ongoing monitoring of the sub-custodian based on best market practice.

7. ESMA suggests some key elements that the depositary should assess to decide whether the risk of delegating the custody task is acceptable. Among them, the depositary has to assess the sub-custodian's financial strength and its ability to provide reasonable care to the financial instruments it would be entrusted with. In the selection process for appointing a sub-custodian, the depositary has also to analyse the legal and regulatory framework of the relevant country sufficiently precisely to be able to assess the degree of enforceability of its contracts, the potential implications of the insolvency of the sub-custodian and other custody risks.

8. Ongoing monitoring should mainly consist in verifying that the sub-custodian correctly performs all of its tasks and complies with the elements specified in the contract. The depositary should review, inter alia, many of the elements assessed during the selection process and put these elements into perspective by comparing them with the evolution of the market. The regular reviews can take the form of mutual visits and/or conference calls between the depositary and the sub-custodian. The frequency of the reviews shall be adapted so as to always remain consistent with market conditions and associated risks.

9. In the event of insolvency of a sub-custodian, the proper segregation of assets may become crucial. Given the liability regime defined by the AIFMD by which the depositary is liable in case of loss of financial instruments held in custody by itself or any of its sub-custodians, the depositary has a great incentive to carefully monitor this point in order to increase the likelihood of recovering the AIF's financial instruments. In order to better cope with situations of insolvency and to react as quickly as possible the depositary could design alternative strategies and possibly select alternative providers. Such contingency planning is all the more useful as it participates to a better understanding of the market by the depositary.

10. Finally, the Commission would like ESMA to develop in its advice a 'comprehensive template of evaluation, selection, review and monitoring criteria'. A majority of respondents to the call for evidence were of the view that it would not be practicable to develop a list of criteria to be considered by every depositary in every delegation scenario. A minority of respondents would agree with the provision of a list only if it provides a high level of flexibility. In line with the recommendation not to adopt a box ticking approach and to avoid being too prescriptive, ESMA's view is that it is not desirable to try and elaborate such a document. ESMA has considered that the depositary's liability for the loss of financial instruments held by its sub-custodians is the strongest incentive depositaries could have to perform adequate due diligences. Furthermore, due diligences are fully documented by industry actors as the documentation is the basis for contractual liability when a problem arises.

Section 3 Segregation

Scope of the Commission's implementing powers

The Commission shall adopt by means of delegated acts, in accordance with Article 56, and subject to the conditions laid down in Articles 57 and 58, measures specifying:

(e) the segregation obligation set forth in paragraph 11 (d) (iii)

Extract from Level 1 Directive

11. The depositary may not delegate to third parties any of its functions as described in this Article, other than those referred to in paragraph 8.

The depositary may only delegate to third parties the functions referred to in paragraph 8, provided that:

(d) the depositary ensures that the third party meets the following conditions at all times during the performance of the tasks delegated to it:

[...]

(iii) 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 particular depositary;

European Commission's Request for Advice to ESMA

1. ESMA is requested to advise the Commission on criteria to be satisfied to comply with the segregation obligation whereby the depositary shall ensure on an ongoing basis that the third party fulfils the conditions referred to in Article 21(11)(d)(iii).

Box 89

Segregation obligation for third parties to which depositaries have delegated part or all of their safekeeping functions (based on Article 16 of Directive 2006/73/EC implementing the MiFID Directive)

1. Where safekeeping functions have been delegated partly or totally to a third party, the depositary must ensure that the third party acts in accordance with the segregation obligation pursuant to Article 21 (11) (d) (iii) by verifying that the third party has put in place arrangements that are compliant with the following requirements:

   (a) to keep such records and accounts as are necessary to enable it at any time and without delay to distinguish assets safekept for the depositary on behalf of its clients from its own assets and from assets held for any other client (including assets belonging to the depositary itself);

   (b) to maintain records and accounts in a way that ensures their accuracy, and in particular their correspondence to the assets safekept for the depositary's clients;

   (c) to conduct, on a regular basis, reconciliations between its internal accounts and records and those of any sub-delegate by whom those assets are safekept;

   (d) to take the necessary steps to ensure that any financial instruments belonging to the depositary's clients entrusted to a sub-delegate are identifiable separately from the financial instruments belonging to the sub-delegate, by means of differently titled accounts on the books of the sub-delegate or other equivalent measures that achieve the same level of protection;

   (e) to take the necessary steps to ensure that cash belonging to the depositary's clients deposited in a central bank, a credit institution or a bank authorised in a third country is held in an

account or accounts identified separately from any accounts used to hold cash belonging to the third party or where relevant the sub-delegate.

2. Where the depositary has delegated its custody functions, monitoring the sub-custodian's compliance with its segregation obligations should ensure the financial instruments belonging to its clients are protected from the event of insolvency of that sub-custodian. If, for reasons of the applicable law, including in particular the law relating to property or insolvency, the requirements described in §1 are not sufficient to reach that objective, the depositary should assess what additional arrangements could be made in order to minimise the risk of loss and maintain an adequate level of protection.

3. The requirements in §1 and §2 should apply mutatis mutandis when the third party has decided to delegate part or all of its tasks to a sub-delegate as foreseen in Article 21 (11).

Explanatory text

1. This section deals with the segregation requirement set out in Article 21 (11) (d) (iii) which the depositary should impose on a third party before it can delegate any of its safekeeping functions.

2. Responses to the call for evidence underscored the practical challenges raised by a full segregation on a client-by-client basis throughout the custody chain. Some stakeholders drew ESMA's attention to the legal and operational realities as well as the limitations existing in some less developed countries (e.g. segregation at sub-custodian level may not be permitted by local law).

3. The suggested advice is based on the requirements set out in Article 16 of Directive 2010/43/EC (see Appendix I). It has been adapted to reflect the fact that Article 21 (11) (d) (iii) does not concern EU investment firms but EU and non EU entities to which a depositary may delegate safekeeping functions and to be consistent with the wording and more importantly the liability regime contained in the AIFMD.

4. In particular, the proposed advice acknowledges that sub-custodians may use omnibus accounts, described in Recital 40 as 'a common segregated account for multiple AIFs'.

5. Further, the segregation obligations apply both to financial instruments held in custody and to assets in record keeping. Subject to the feedback to be provided by the industry, ESMA has considered that the requirements set out in §1 should be applicable in both cases.

6. §2 sets out specific requirements when custody tasks are delegated which should be read bearing in mind that the main objective of the segregation requirements all along the custody chain is to prevent the loss of assets as a result of the insolvency of a sub-custodian. These requirements should therefore be read in conjunction with the due diligence duty to assess the regulatory and legislative framework detailed in Box 88 §1 (a). However in some countries, the segregation requirements defined in the AIFMD may not be sufficient to make the assets insolvency remote. Consequently, ESMA suggests that where the effects of segregation are not recognised by the local insolvency law, to the extent possible, additional measures should be taken to limit the risk of loss and ensure an adequate level of protection.

Q46: What alternative or additional measures to segregation could be put in place to ensure the assets are 'insolvency-proof' when the effects of segregation requirements which would be imposed pursuant to this advice are not recognised in a specific

market? What specific safeguards do depositaries currently put in place when holding assets in jurisdictions that do not recognise effects of segregation? In which countries would this be the case? Please specify the estimated percentage of assets in custody that could be concerned.

V.IV. The depositary's liability regime

1. The depositary's liability regime is a central issue of the AIFMD and probably one of the most controversial with which ESMA has to deal in its advice. ESMA has strived to strike the right balance between the directive's objective to set strict rules to ensure a high level of investor protection while at the same time not putting the entire responsibility on the depositaries as this would counterproductively create the incentive for regulatory arbitrage and in some cases may lead to increased systemic risk.

2. Pursuant to Article 21 of the AIFMD, the depositary's liability can be triggered either in the event of failure or negligence or in the event of loss of a financial instrument held in custody by the depositary itself or a sub-custodian. Implementing measures only deal with the second situation, i.e. where the financial instruments in custody are 'lost'. Such a 'loss' is distinct from 'investment' loss for investors due to a decrease in the value of the assets which stems from consequences of investment decisions. The depositary is never liable for the investment value decrease of an asset belonging to the AIF since the decrease stems from the consequences of investment decisions.

3. The AIFMD reinforces significantly the depositary's liability regime compared to its liability under the UCITS IV framework in case of 'loss' of the financial instruments in custody by introducing the obligation for the depositary, to return a financial instrument of the identical type or the corresponding amount, without undue delay unless it can demonstrate that the loss was a result of an external event beyond reasonable control, the consequences of which were unavoidable despite reasonable efforts to the contrary.

4. The ultimate objective of the implementing measures when it comes to the depositary's liability is to ensure a clear, coherent and robust framework that can be applied across jurisdictions and ensure a level playing field.

5. In the proposed advice, the approach taken attempts to provide clear definitions of what would constitute (i) the loss of a financial instrument, (ii) an external event beyond the reasonable control of a depositary, the consequences of which would have been unavoidable despite reasonable efforts and (iii) the objective reason which could enable a depositary to discharge its responsibility by transferring it to a sub-custodian. Nevertheless it leaves some margin for interpretation to ensure all situations are covered. Depositaries, AIFs and AIFMs, investors, competent authorities and all interested parties will have to assess on a case by case basis whether the event triggers the depositary's liability to return an identical financial instrument or the corresponding amount without undue delay.

6. With regard to the definition of loss, ESMA has put forward a suggestion which should facilitate a straightforward assessment of the event and is designed to limit the loss to situations where the financial instruments are permanently lost as opposed to temporarily unavailable. The proposed definition thus covers situations where the AIF has been permanently deprived of its ownership right over the financial instruments or is permanently unable to dispose of them. It further ensures the 'loss' resulting from a fraudulent behaviour is included in the scope of the depositary's liability.

7. As for the external event beyond the depositary's reasonable control, ESMA has set out a three step approach to clarify how this requirement should apply, which reflects the fact that the burden of proof lies with the depositary. The approach can be illustrated by a decision tree. Not to be held liable, the

depositary would first have to demonstrate that the event which led to the loss of the financial instruments held in custody was 'external', then that it was 'beyond its reasonable control' which should be understood as an event for which the depositary could not prevent the occurrence by reasonable efforts, and finally that the depositary could not have prevented the loss with reasonable efforts. ESMA provides some guidance in relation to the actions which could be expected of the depositary in that last step.

1 Loss of financial instruments

Scope of the Commission's implementing powers

The Commission shall adopt by means of delegated acts, in accordance with Article 56, and subject to the conditions laid down in Articles 57 and 58, measures specifying:

[...]

(a) the conditions and circumstances subject to which financial instruments held in custody are to be considered as lost;

Extract from Level 1 Directive

12. The depositary shall be liable to the AIF, or to the investors of the AIF, for the loss by the depositary or a third party to whom the custody of financial instruments held in custody according to point (a) of paragraph 8 has been delegated.

In the case of such a loss of a financial instrument held in custody, the depositary shall return a financial instrument of the identical type or the corresponding amount to the AIF or the AIFM acting on behalf of the AIF without undue delay. The depositary shall not be liable if it can prove that the loss has arisen as a result of an external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary.

European Commission's Request for Advice to ESMA

1. ESMA is requested to advise the Commission on the conditions and circumstances under which financial instruments held in custody pursuant paragraph 8(a) shall be considered as 'lost' according to Article 21(12). In its advice, ESMA should take into account the various legal rights attached to the financial instruments depending, for example, on the legal concepts ('ius ad rem' vs. 'ius in personam') used in the jurisdiction where they have been issued and any legal restrictions applicable to the place where they are kept in (sub-) custody.

2. In its advice, ESMA should specify circumstances when such financial instrument should be considered permanently 'lost', to be distinguished from circumstances when such financial instruments should be considered temporarily 'unavailable' (held up or frozen).

To that end, ESMA shall consider inter alia the following circumstances:
- Insolvency of, and other administrative proceedings against, a sub-custodian;
- Legal or political changes in the country where financial instruments are held in sub custody;
- Actions of authorities imposing restrictions on securities markets;
- Risks involved through the use of settlement systems; and
- Any other circumstances which may prevent the AIF from using or disposing of its assets that are kept in custody by a depositary or a sub custodian.

Proposed Advice

Box 90

Definition of loss

1. Financial instruments held in custody by the depositary or, as the case may be, by a sub-custodian should be considered 'lost' within the meaning of Article 21 (12) if one of the following conditions is met:

    (a) a stated right of ownership is uncovered to be unfounded because it either ceases to exist or never existed;

    (b) the AIF has been permanently deprived of its right of ownership over the financial instruments;

    (c) the AIF is permanently unable to directly or indirectly dispose of the financial instruments.

2. The assessment of the loss of financial instruments must follow a documented process readily available to competent authorities and lead to the notification of investors in a durable medium taking into account the materiality of the loss.

Where an AIF is permanently deprived of its right of ownership in respect of a particular instrument, but this instrument is substituted by or converted into another financial instrument or instruments, for example in situations where shares are cancelled and replaced by the issue of new shares in a company reorganisation, this is not considered to be an example of the loss of financial instruments held in custody.

In case of insolvency of a sub-custodian, financial instruments should be considered 'lost' as soon as one of the conditions set out in §1 is met with certainty and at the latest, at the end of the insolvency proceedings. To that end, the AIFM should monitor closely the proceedings to determine whether all or part of the financial instruments entrusted to the sub-custodian are effectively lost.

In case of a fraud whereby the financial instruments have never existed or have never been attributed to the AIF (e.g., as a result of a falsified evidence of title, accounting fraud, etc.), all conditions described in §1 should be deemed to be met.

Explanatory text

8. Respondents to the call for evidence stressed the importance of the notion of permanence to define the loss. They added that there should be no prospect of recovering them, thus excluding situations where the assets are unavailable or temporarily frozen.

9. A respondent suggested referring to the three cumulative criteria of the force majeure to define a loss (externality, unpredictability and irresistibility). In their opinion, the AIFMD already includes two of these criteria, the implementing measures would only have to introduce the notion of 'unpredictability'. Another suggestion was to rely on three criteria: the asset is no longer held i) for the account of the AIF; ii) by the AIF; iii) by the custodian.

10. Some respondents to the call for evidence underlined that defining a 'loss' in a broad way may increase systemic risk by dissuading a number of entities from acting as depositaries.

11. For the industry, the insolvency of a sub-custodian, the risks involved through the use of settlement systems or any situations which prevent the AIF of disposing of its assets should not be considered as a loss. In contrast, legal or political changes or actions of authorities imposing restrictions on securities markets can be considered as a loss.

12. Pursuant to Article 21 (12), the 'loss' of a financial instrument in custody is a necessary condition for the depositary's obligation to return a financial instrument of an identical type or the corresponding amount to be triggered. However, it is not sufficient since the depositary would not be liable if it can demonstrate that the loss resulted from an external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary.

13. Therefore, in the first instance ESMA has set out the conditions to be met for financial instruments in custody to be considered 'lost'.

14. Three types of situation where financial instruments may be lost have been identified:

- where the financial instruments no longer exist or never did
- where the financial instruments exist but the AIF has lost its right of ownership over them
- where the AIF still holds the ownership right but cannot dispose of the financial instruments

15. The first type of situation corresponds to the most obvious kind of loss. In that scenario, the financial instruments simply do not exist, either they have 'disappeared' by means of an accounting error for instance or they may have never existed, which could be the case as a result of a fraud. The first condition described under §1 (a) is meant to capture situations where the loss of financial instruments is due to fraudulent conducts. For example, if the AIF registered the ownership of a financial instrument in its accounts on the basis of a falsified document, the evidence of its ownership right will be considered as having never existed.

16. For the two other types of situations, the length of time during which the situation persists must be taken into account. The financial instruments will only be considered effectively lost if the AIF has been deprived of its right of ownership or is unable to dispose of them on a permanent basis and not simply temporarily.

17. For the avoidance of doubt, it should be clear that any intentional transfer of ownership by the AIF or the AIFM acting on behalf of the fund to a third party (e.g. a prime broker or a collateral agent) should not be considered as a 'loss'. Such situations are treated in the relevant sections of this paper.

18. Similarly, where there is a distinction between the legal ownership and the beneficial ownership of the assets, it should be understood that the definition refers to the loss of the beneficial ownership right.

19. ESMA believes it is up to the AIFM to determine whether the financial instruments are lost, to document its assessment and inform the investors in an appropriate way. For instance, where the loss is significant with regard to the fund's NAV, the loss should prompt an ad hoc communication with investors. Where it is not significant and will not have a material impact on the AIF, its investors or the AIFM, it should be sufficient to include that information in the annual report.

20. In the event of insolvency of a sub-custodian, the financial instruments belonging to the AIF which were entrusted to that sub-custodian should not be deemed lost until it appears clear that they will not be recovered. Subject to local insolvency law, if the assets were appropriately segregated at the sub-custodian, the AIF should be able to recover its assets, the only question is when. The AIFM should then monitor closely the proceedings and regularly assess whether there is a reasonable chance of recovering all or part of the assets. As soon as there is a certainty that part of the financial instruments are lost, the AIFM should record that loss in its books. In most cases, the assessment of whether or not financial instruments have effectively been lost will only be possible at the end of the proceedings.

ESMA believes that it would not be appropriate to deem the instruments lost from the beginning of the proceedings as (i) it is not possible at that stage to determine with certainty whether financial instruments belonging to the AIF have effectively been lost and (ii) that would trigger the depositary's liability which may in turn significantly increase the systemic risk

21. No particular mechanism has been defined to address situations where the depositary and the AIF or the AIFM have different appreciations of the situation. It is assumed that in most cases, for non controversial situations or where the amounts at stake are low, they will find a common ground within their contractual relationship. For more complex cases, ESMA believes it will be up to the relevant courts to settle any dispute.

2 External events beyond reasonable control

Scope of the Commission's implementing powers
The Commission shall adopt by means of delegated acts, in accordance with Article 56, and subject to the conditions laid down in Articles 57 and 58, measures specifying:
[…]
(g) what is to be understood by external events beyond reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary pursuant to paragraph 12;

Extract from Level 1 Directive
12. The depositary shall be liable to the AIF or to the investors of the AIF, for the loss by the depositary, or a third party to whom the custody of financial instruments held in custody according to point (a) of paragraph 8 has been delegated.

In the case of such a loss of a financial instrument held in custody, the depositary shall return a financial instrument of the identical type or the corresponding amount to the AIF or the AIFM acting on behalf of the AIF without undue delay. The depositary shall not be liable if it can prove that the loss has arisen as a result of an external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary.

European Commission's Request for Advice to ESMA

1. ESMA is requested to advise the Commission on the conditions and circumstances for events to be considered as:
   (i) external;
   (ii) going beyond reasonable control, and;
   (iii) having consequences which would have been unavoidable despite all reasonable efforts to the contrary.
2. If possible, ESMA is requested to advise the Commission on a non-exhaustive list of events where the loss of assets can be considered to be a result of an external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary. ESMA is encouraged to consider the appropriate form (e.g. guidelines) of such a list.

Box 91

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

The depositary will not be liable for the loss of financial instruments held in custody by itself or by a sub-custodian if it can demonstrate that all the following conditions are met:

1. The event which led to the loss did not occur as a result of an act or omission of the depositary or one of its sub-custodians to meet its obligations

2. The event which led to the loss was beyond its reasonable control, i.e. it could not have prevented its occurrence by reasonable efforts

3. Despite rigorous and comprehensive due diligences it could not have prevented the loss.

   Subject to requirements of §1 and §2 being fulfilled, the depositary or the sub-custodian could be regarded as having made reasonable efforts to avoid a loss of a financial instrument held in custody if it can prove that it has taken all of the following actions:

   (a) it has ensured that it has the structures and expertise that are adequate and proportionate to the nature and complexity of the assets of the AIF, to identify in a timely manner and monitor on an ongoing basis any external events which it considers may result in a loss of a financial instrument held in custody

   (b) it has reviewed on an ongoing basis whether any of the events it has identified under point (a) present a significant risk of loss of a financial instrument held in custody

   (c) where it has identified actual or potential external events which it believes present a significant risk of loss of a financial instrument held in custody, it has taken appropriate actions, if any, to prevent or mitigate the loss of financial instruments held in custody

The above described conditions will apply to the delegate when the depositary has contractually transferred its liability to a sub-custodian.

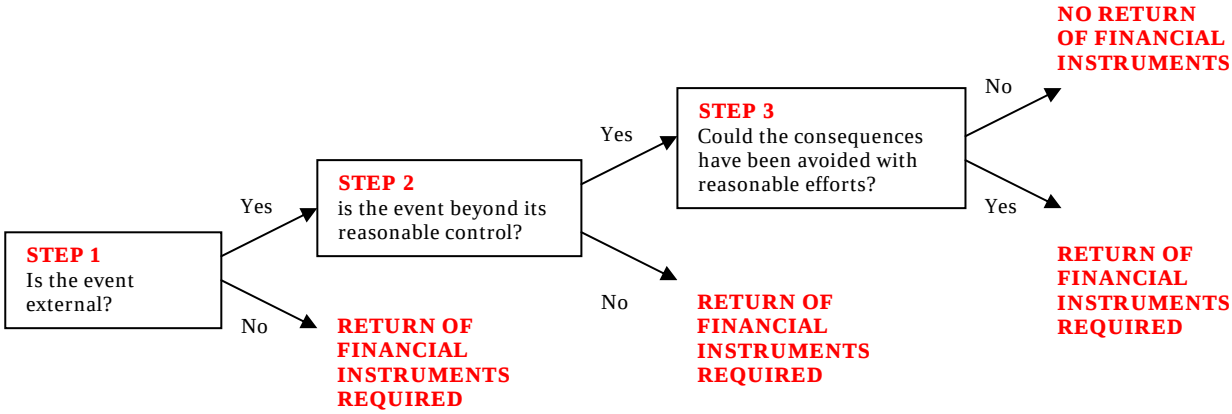
Explanatory text

22. Many respondents to the call for evidence shared the view that acts of State and acts of God should be considered as external events beyond reasonable control. Fraud, insolvency or default of clearing or settlement systems were also often quoted as an external event beyond reasonable control. One respondent suggested drawing a 'white list' of external events where the depositary would be deemed liable.

23. Pursuant to Article 21 (12) of the AIFMD, the loss of financial instruments held in custody triggers an obligation for the depositary to return a financial instrument of the identical type or the corresponding amount without undue delay unless it can prove that the loss has arisen as a result of an 'external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary'.

24. In the approach under consideration, each of the three elements is deemed necessary for the depositary to discharge its liability. All three conditions must be met for the depositary not to be held liable for the loss. The assessment should follow the steps as described in Figure 1.

Figure 1: How to assess whether the depositary is required to return an identical asset or the corresponding amount?



External event

25. The first step is to determine whether the event which led to the loss was 'external'.

26. ESMA carefully considered the different types of events which could lead to a loss of financial instruments under custody notably on the basis of examples provided in the responses to the call for evidence, and came to the conclusion that a definition was necessary to help the parties involved in the assessment of that criterion. Although some events appear by nature 'external' to the depositary (e.g., nationalisation, war, legal or political changes, etc.), other events are not as easy to categorise.

27. ESMA has identified three types of event:

- Acts of State or Acts of God
- Events related to the insolvency of a sub-custodian
- Other events including operational failures, fraud (...)

28. Taking into account Article 21 (12) and Article 21 (13), which state that the depositary's liability is not affected by the delegation of all or part of its custody function, ESMA suggests that, when assessing whether the event which caused the loss is external or internal, one should establish whether that event is external to the depositary and / or its sub-custodian (where the depositary has delegated the custody of the financial instruments to a third party). Consequently, ESMA proposes to consider that an event should be deemed 'external' if it did not occur as a result of an act or omission of the depositary or its sub-custodian where the financial instruments were held in custody.

29. In that framework, if the loss was due, for instance, to an accounting error or an operational failure at the depositary or its sub-custodian, that would be considered as an 'internal' event and would trigger the depositary's obligation to return a financial instrument of an identical type or a corresponding amount. Similarly, in case of a fraud which would have taken place within the depositary's network or one of its sub-custodians, the depositary would be held liable on similar grounds.

30. On the contrary, ESMA believes that the event of, for instance, a market closure or of a technical failure at the level of the Central Security Depositary or any other settlement system should be considered 'external'.

31. As for the insolvency of a sub-custodian, as suggested in the draft advice in relation to the definition of a 'loss', ESMA considers that the financial instruments held in custody by that entity should not automatically be deemed lost since there is a reasonable chance they will be recovered at the end of the legal proceedings thanks notably to the sub-custodian's obligation to comply with the segregation requirements defined in Article 21 (11) (d) (iii) and the corresponding implementing measures. However, ESMA has identified three situations where instruments may be lost following the bankruptcy of a sub-custodian: (i) where the sub-custodian failed to implement the segregation rules, (ii) where the law of the country where the instruments were held in custody does not recognise the effects of such segregation requirements and (iii) finally some industry representatives have highlighted that in any insolvency, a small percentage of the assets may be lost due to the disruption in the entity's activity in relation to its default.

32. In the second situation, where the financial instruments are 'lost' following the liquidation of a sub-custodian despite appropriate segregation of assets, because the law of the country where the financial instruments were held in custody does not recognise the effects of segregation, ESMA believes that the loss of those financial instruments should be considered due to be an external event, i.e. the local legal/regulatory framework. In the two other situations – ceteris paribus – the depositary would be held liable.

Beyond reasonable control

33. If the event can be qualified as 'external', the next step is to assess whether the event was beyond the depositary's reasonable control. A simple definition is suggested by which the event would be considered beyond the depositary's control if there was nothing the depositary could reasonably have done to prevent its occurrence.

34. That definition will naturally include all events which can be qualified as an act of State or an act of God (i.e. a Government / Government agency decision which impacts the financial instruments held in custody by the depositary or a natural disaster). In that framework, loss resulting from nationalisation, war, etc. would automatically be considered beyond the depositary's reasonable control. However, the depositary would have to alert the AIFM or the AIF where it has identified such an event and assessed there was a high risk of occurrence.

[...] the consequences of which would have been unavoidable despite all reasonable efforts to the contrary.
Definition of 'reasonable efforts' to avoid the loss of financial instruments held in custody

35. Finally, the depositary has to demonstrate that the loss could not have been avoided despite 'reasonable efforts'. To avoid having different interpretations across jurisdictions as to whether the depositary could prevent the loss, the draft advice sets outs the measures the depositary would be required to take to identify and monitor the risk of loss of the financial instruments it holds in custody.

36. The requirements are for the depositary (i) to ensure it has appropriate means to identify and monitor events deemed beyond its control which could lead to a loss; (ii) to regularly update its assessment of those events; (iii) to take appropriate action when needed.

37. In some instances, there may not be any appropriate action to take except informing the AIFM. For example, in the event of the nationalisation of a company, it goes without saying that there is no 'appropriate action' to be taken by the depositary within reasonable efforts. In all cases, it should be clear that the depositary has a duty to inform the AIFM of the risks identified but that such information is not sufficient as such for the depositary to discharge it liability.

38. In a situation where the depositary believes the only appropriate action is to dispose of the financial instruments, it must duly inform the AIFM, who must instruct the depositary in writing whether to continue holding the financial instruments or to dispose of them as this decision forms part of portfolio management which is the AIFM's responsibility. If the depositary is instructed to continue holding the assets, any such instruction must be reported to the competent authorities and the AIF's investors in a timely manner depending on the materiality of the potential impact of a loss of those instruments. The disclosure requirement should prompt the AIF / AIFM to take due consideration of its depositary's recommendations.

39. Where the depositary having notified the AIFM several times of what it deems to be a significant custody risk remains concerned that the level of protection of the financial instruments is not sufficient, it should notify the competent authorities and assess whether to request the authorisation to transfer its liability to a sub-custodian or ultimately consider terminating the contract. As the entity in charge of ensuring the AIF's assets are properly safekept, the depositary's ultimate recourse when it is not satisfied with the level of protection and the AIFM has not taken any action despite its warnings, is to put an end to its contract with the AIF / AIFM provided the AIF is given a period of time to find another depositary in accordance with national law. Such a possibility should ensure the AIFM / AIF act upon the depositary's reiterated warnings.

3 Objective reason to contract a discharge

Scope of the Commission's implementing powers
The Commission shall adopt by means of delegated acts, in accordance with Article 56, and subject to the conditions laid down in Articles 57 and 58, measures specifying:
[…]
(h) the conditions and circumstances under which there is an objective reason to contract a discharge pursuant to paragraph 13.

Extract from Level 1 Directive
The depositary's liability shall not be affected by any delegation referred to in paragraph 11.
Notwithstanding the first subparagraph of this paragraph, in case of a loss of financial instruments held in custody by a third party pursuant to paragraph 11, the depositary may discharge itself of liability if it can prove that:
(a) all requirements for the delegation of its custody tasks set out in the second subparagraph of paragraph 11 are met;
(b) a written contract between the depositary and the third party expressly transfers the liability of the depositary to that third party and makes it possible for the AIF or the AIFM acting on behalf of the AIF to make a claim against the third party in respect of the loss of financial instruments or for the depositary to make such a claim on their behalf;
(c) a written contract between the depositary and the AIF or the AIFM acting on behalf of the AIF, expressly allows a discharge of the depositary's liability and establishes the objective reason to contract such a discharge.

European Commission's Request for Advice to ESMA

1. ESMA is requested to advise the Commission on the conditions and circumstances under which there is an objective reason for the depositary to contract a discharge pursuant to Article 21(13).

2. In its advice, ESMA is encouraged to provide an indicative list of scenarios that are to be considered as being objective reasons for the contractual discharge referred to in Article 21 (13).

40. The respondents to the call for evidence had different opinions about how objective reasons to contract a discharge should be defined. Some responses considered that wherever there is a good, practical reason for delegating safekeeping functions, it should be considered an objective reason to contract a discharge. Other responses were in favour of restricting the cases for exemption of liability as much as possible and recalling that the depositary should act in the best interests of investors at all time.

41. Responses to the call for evidence suggested some situations where there would be an objective reason to contract a discharge including for example where the AIF/AIFM has directed the depositary to appoint a particular third party. It also refers to situations where access to a particular market is only possible through the appointment of a third party and the AIF or AIFM requires access to such a market and accepts any risk arising from that investment decision.

Box 92

Objective reasons for the depositary to contract a discharge

The depositary will be deemed to have an objective reason to contractually discharge itself of its liability in accordance with the requirements set forth in Article 21 (13) if it can demonstrate that:

Option 1

1. it had no other option but to delegate its custody duties to a third party (e.g. as a result of legal constraints); or
2. it has agreed with the AIF or as the case may be the AIFM through a written agreement that it is in the best interest of the AIF and its investors to delegate such duties (e.g. if the delegate is in a country where the depositary does not operate).

Option 2

Where the AIF or, as the case may be, the AIFM and the depositary have explicitly agreed through a written contract that the depositary can discharge its responsibility, it should be considered that the requirement to have an objective reason is fulfilled.

Explanatory text

42. The AIFMD states that the depositary's liability shall not be affected by the delegation of its safekeeping duties to a third party. However, under certain conditions defined under Article 21 (13) of the directive, the depositary has the possibility to discharge its liability in the event of loss of financial instruments held in custody by a third party. Those conditions which include a transfer of responsibility to the sub-custodian must be specified in a written contract signed between the depositary and the sub-custodian, contract which must define the 'objective reason' justifying this contractual transfer of liability.

43. ESMA believes it is of the utmost importance to have workable criteria to define the objective reason for a contractual discharge in order for this provision foreseen in the Directive to be effectively implemented by the industry.

44. ESMA is consulting on two options. The first approach envisaged would require the depositary to demonstrate that it either had to appoint a specific sub-custodian as a result of a legal requirement in the country in which the AIFM wishes to invest or that the delegation of its custody tasks to the sub-custodian is in the best interest of the AIF, which could be the case where the sub-custodian has a particular expertise in relation to the financial instruments to be held in custody or in the relevant market. The best interest of the AIF and its investors would be achieved if there is no disadvantage for them deriving from the liability transfer. The second avenue ESMA is exploring would consist in considering that the other safeguards introduced in the AIFMD as conditions for the discharge of the depositary's responsibility (transfer, written agreement, disclosure, etc.) are protective enough. This approach would warrant a broad definition of 'objective reason' as proposed in option 2.

45. It is important to stress that the AIFMD clearly states that the transfer of liability can intervene all along the custody chain (see before last § of Article 21 (11)).

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

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

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

Q50: Are there other events which should specifically be defined/presumed as 'external'?

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

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

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

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

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

1. Article 4(1)(v) of 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.'

2. Respondents to ESMA's call for evidence were clearly of the view that a single method of calculating leverage may not be appropriate for all fund strategies. However, there was support for considering CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (Ref. CESR/10-788, Boxes 24 and 25), notwithstanding the drawbacks to that approach identified by industry respondents to the relevant consultation. In addition, it was highlighted that there were some specific issues in relation to investors in private equity funds investing via loan agreements rather than capital.

3. Many respondents provided more detailed feedback, including on the methods through which leverage may be created, while some highlighted concerns as to how AIFMs should treat borrowings or other exposures within portfolio companies, subsidiary companies and shares purchase in listed companies.

4. ESMA views leverage as a magnifying factor that has the potential to increase the gains or losses of an AIF with respect to investment decisions. More specifically it can be considered as the additional exposure gained through any form of contractual or other legal relationship that gives AIF the opportunity to earn greater returns or suffer greater losses than would otherwise have been the case. However ESMA considers that this magnifying factor will in some cases have boundaries, specifically where AIF utilise options, financial instruments with optionality or hold positions in the form of contracts or participations where the invested capital of the AIF is the limit of that exposure. Such a 'bounded' exposure could be obtained through a call spread (a combination of a long position in one call and a short position in another call both of which reference the same underlying asset), through which the AIF is exposed to the potential of a known profit or loss from the instrument.

5. ESMA considers that it is important to highlight the context within which this advice is being provided. Specifically ESMA notes the following obligations on AIFM with respect to the use of leverage:

   - the requirement for AIFM to set out in their authorisation the 'policy as regards the use of leverage'[24];
   - the requirement for the AIFM to set 'a maximum level of leverage which they may employ on behalf of each AIF it manages'[25];
   - leverage disclosures to investors as set out in Article 23(5);
   - leverage disclosures to competent authorities as set out in Article 24(4); and
   - the requirement that 'AIFM must demonstrate that the leverage limits set by it for each AIF it manages are reasonable and that it complies with those limits at all times .'[26]

[24] Article 7(3)a
[25] Article 15(4)
[26] Article 25(3)

6. The AIFMD uses the phrase 'increases the exposure' when referring to leverage. An AIF that only holds equity shares in listed companies would not be said to be using leverage as the exposure of the AIF is the same as the AIF's net asset value (NAV). A simple example of leverage is where that same AIF then decides to purchase futures on an equity index (e.g. the Euro Stoxx 50), the AIF is now leveraged because it has increased the AIF's exposure to a given investment (in this example the Euro Stoxx 50) above its capital. Another example could be where the AIF instead sells futures in the Euro Stoxx 50; the extent to which this increases the exposure of the AIF above its capital will depend on correlations between the long portfolio and the short futures such that they can be said to be offsetting– netting and hedging arrangements may therefore be crucial in determining the exposure of the AIF and therefore the degree of leverage.

7. ESMA considers that the concept of the 'exposure of an AIF' should be more clearly defined; this advice seeks to ensure a harmonised regime for the calculation of the AIF's exposure and in doing so has considered the CESR Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS ('CESR Guidelines')[27]. These guidelines seek to provide a methodology for calculating the 'global exposure of a UCITS' which is broadly similar to the Commission request to provide a description of relevant methods by which AIFM increase the exposure of AIF.

8. ESMA would like to note that, in comparison to UCITS, the population of AIFs are significantly more heterogeneous and many use financial derivative instruments as part of complex investment strategies. It is therefore important to ensure that the method(s) of calculating leverage comprehensively captures all those investment strategies pursued by AIFM's within its scope.

9. Some AIFM will also be managing UCITS which will require them to follow the CESR Guidelines on the calculation of global exposure. The Commission has asked ESMA to consider 'the appropriateness, accuracy, cost, comparability and practicability of the different methods' of calculating leverage. Therefore using the commitment methodology as a basis may lead to a reduced administrative burden for certain AIFM that also manage UCITS.

10. The CESR Guidelines permit a Value at Risk (VAR) approach to the calculation of global exposure. This approach was given due consideration by ESMA, however, it was concluded that this was inconsistent with the legislator's intentions in the Level 1 Directive, particularly given that the definition of leverage explicitly cited examples of cash borrowings and derivative positions. Furthermore, a VAR approach utilises correlations which have a propensity to break down in stressed market conditions so if ESMA were to adopt this approach there would be a tendency for the calculation methodology not to work in the very conditions where a robust leverage figure may be most valuable to competent authorities and investors.

11. ESMA understands that the exposure of the AIF is the extent to which the AIF may potentially be impacted by market risks; however in some cases there is directional bias or netting arrangements and this understanding may need to be adjusted to take into account cases where the amount of losses, under stressed market conditions, may be limited.

12. ESMA would like to emphasise that the commitment approach under the CESR Guidelines can be calculated by most if not all AIFM, however for some AIFM the resulting figure for exposure may be misleading. Specifically that approach has as its underlying assumption the concept that the relative

[27] http://www.esma.europa.eu/data/document/10_788.pdf

movements in the exposure of the AIF will be the same independent of the size of the change in the underlying stock or reference asset i.e. it does not take into account convexity and that in certain cases the exposure of an AIF is bounded.

13. The advice in this section sets out the methods that AIFM can use to increase the exposure of the AIF and how leverage may be calculated. At the outset it is worth clarifying that AIFM, when calculating exposure, should 'look through' corporate structures to the extent that those structures have recourse to the AIF via cross-collateralisation or guarantees[28]. The AIFM should also 'look though' financial derivative instruments or other instruments where leverage is embedded in the contract so as to convert to an equivalent underlying position.

14. ESMA has considered the extent to which its proposed advice should permit AIFM to use netting or hedging arrangements to reduce the value of the exposure of the AIF calculated in accordance with the Directive and its implementing measures. ESMA has concluded that the use of these arrangements can generally only be considered as reducing the exposure of the AIF in specific circumstances, in accordance with the CESR Guidelines, and must only be used to reduce the exposure of an AIF when it is likely that such arrangements will remain materially effective in stressed market conditions.

15. ESMA also considers that borrowing of a temporary nature that is fully covered by capital commitments from the AIF's investors should not be considered to increase the exposure of an AIF.

Scope of the Commission's implementing powers

The Commission shall adopt by means of delegated acts in accordance with Article 56, and subject to the conditions laid down in Articles 57 and 58, measures specifying:

(a) the methods of leverage, as defined in point (v) of paragraph 1, including any financial and/or legal structures involving third parties controlled by the relevant AIF; and
(b) how leverage is to be calculated.

Extract from Level 1 text - Article 4(1)(v)

'Leverage' means 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;

Commission's Request for Advice to ESMA (CESR)

1. CESR is requested to provide the Commission with a description of relevant methods by which AIFM increase the exposure of AIF whether through borrowing of cash or securities, or leverage embedded in derivative positions or by any other means, including any financial and/or legal structures involving third parties controlled by the AIF. This description or mapping should distinguish between the various business models and approaches to leverage in the AIFM industry. In its advice, CESR should take into account the guidance provided in recital 14[29].

[28] Guarantees should include circumstances where there is an expectation that the AIF will contribute to a third party even though there is no legally enforceable obligation.
[29] Now recital 78 in the version published in the Official Journal.

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

Proposed Advice

Box 93

General Provisions on Calculating the Exposure of an AIF

1. 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 in all 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 defined.

2. AIFM shall calculate leverage as the exposure of the AIF divided by its net asset value, where the exposure of the AIF is calculated in accordance with paragraph 3 or 4.

3. AIFM shall calculate the exposure of each AIF under its management in accordance with the Gross Method set out in Box 95 and the Commitment Method set out in Box 96. The exposure of the AIF should represent the extent to which the AIF may be impacted by the market risks attributable to its positions.

4. To comply with its obligations with respect to Article 25(3) of Directive 2011/61/EU, AIFM may in addition to calculating exposure under the Gross Method and Commitment Method, and upon notification to the competent authorities of its home Member State, calculate the exposure of an AIF under its management in accordance with the Advanced Method set out in Box 97.

5. The notification referred to in paragraph 4 may be made by the AIFM to the competent authorities of its home Member State at the same time as the AIFM applies for authorisation in accordance with Article 7 of Directive 2011/61/EU and must include:

   (a) the name of the AIF for which the AIFM will use the Advanced Method to calculate exposure;
   (b) an explanation of why the Gross Method and the Commitment Method do not provide an accurate reflection of the exposure of the AIF it manages;
   (c) the methodology employed for the calculation of the exposure of the AIF in accordance with the Advanced Method; and
   (d) a justification of the key assumptions used in the calculation of the exposure of the AIF under the Advanced Method.

6. The competent authorities of the home Member State of the AIFM may request additional information to that contained in the notification referred to in paragraph 4.

7. The AIFM should be able to demonstrate that the exposure calculated in accordance with Box 97 has been undertaken in a conservative manner which has taken account of the material risks to which the AIF is exposed and therefore does not understate the exposure of the AIF.

8. AIFM shall, on request, make available to investors the methodology employed for the calculation of the exposure of an AIF under its management in accordance with the Advanced Method.

9. AIFM shall have appropriately documented procedures to calculate the exposure of each AIF under its management in accordance with the Gross Method, the Commitment Method and, in respect of each AIF for which the AIFM has submitted the notification referred to in paragraph 4, the Advanced Method. The AIFM shall also ensure that the calculation is consistently applied.

10. Where changes are made to the procedures referred to in paragraph 8 that impact the calculation of the exposure of the AIF and result in a material change to the level of leverage disclosed by the AIFM in respect of the AIF in accordance with Article 23(5) of Directive 2011/61/EU, the AIFM shall notify the AIF's investors and the competent authorities of the home Member State. The notification shall include the reasons for the change in procedures and the impact on the level of lever-

age.

11. To comply with its obligations in accordance with Article 23(5) of Directive 2011/61/EU and Box 108, AIFM shall disclose to investors on a regular basis, the level of leverage with reference to the Gross Method and must in addition disclose the level of leverage with reference to the Commitment Method or, where applicable, the Advanced Method.

Explanatory Text

16. The following advice sets out a framework that AIFM must use when calculating exposure. ESMA has taken into account the appropriateness, accuracy, cost, comparability and practicality of different methods and has arrived at the conclusion that no one single method can be applied to the wide range of AIF that are within the scope of the Directive. Therefore ESMA has set out two mandatory methods for calculating the AIF's exposure in addition to an additional method that may be used by AIFM in certain circumstances.

17. ESMA considers that it is important to receive information about an AIF's exposure both before and after hedging and netting arrangements adjustments have been applied. Specifically the degree to which overall exposure differs as a result of these arrangements may provide useful information as to the extent to which the AIFM's judgement is used. Competent authorities may then seek to satisfy themselves that the netting and hedging arrangements are being applied in line with the CESR Guidelines.

18. ESMA therefore advises that all AIFM should calculate exposure using the Gross Method and Commitment Method (further information on the specificities of these methods is set out later in this paper) and, upon prior notification to the competent authority calculate exposure using the Advanced Method. An Advanced Method is required to reflect the specificities of certain strategies where, for example, the following problems may occur:

    - the CESR Guidelines would not permit certain hedging and netting arrangements even though the arrangements would remain materially effective in stressed market conditions; and
    - the application of the delta-adjusted approach to certain financial derivative instruments would not be reflective of the pre-defined maximum losses, for example options where the loss boundaries are defined in advance.

19. ESMA considers that a notification rather than an authorisation procedure in relation to the use of the Advanced Method by an AIFM is sufficient to avoid placing an unnecessary regulatory burden on competent authorities. The notification needs to be made for each AIF for which it will calculate exposure using the Advanced Method. Competent authorities may choose to scrutinise this further and therefore ESMA has included in its advice a recommendation that certain minimum pieces of information should be included in that notification. Specifically, the AIFM should include an explanation of why the Gross Method and Commitment Method do not provide an accurate reflection of the exposure of the AIF, as well as a justification of the key assumptions together when calculating exposure using this method. More information may subsequently be requested by the competent authority and the AIFM should be able to demonstrate that the calculation is conservative and does not understate the exposure of the AIF.

20. ESMA considers that the Advanced Method of calculating exposure should rely on the judgement of AIFM, albeit within certain stated parameters. When AIFM change the methodology such that it

materially changes the resulting calculation of exposure a notification procedure should be triggered to investors and the competent authorities.

21. Harmonisation of application is not the sole aim of the Advanced Method and therefore investors and competent authorities should be able to view the methodology employed if they wish to make meaningful comparisons between AIFs.

22. ESMA advises that where leverage is required to be disclosed to investors in accordance with the AIFMD the level of leverage calculated under the Gross Method must be disclosed. The AIFM must also disclose the level calculated under either the Commitment Method or the Advanced Method.

Proposed Advice

Box 94

Exposure Related Definitions

'Netting arrangements' means combinations of trades on financial derivative instruments and/or security positions which refer to the same underlying asset, irrespective – in the case of financial derivative instruments – of the contracts' due date and where those trades on financial 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.

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

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

'Financial derivative instruments' means options, futures, swaps, forward rate agreements and other derivative or embedded derivative positions including derivative contracts as defined in point 4 to 10 of Section C of Annex I of Directive 2004/39/EC.

'**Capital commitment**' means the contractual commitment of an investor to provide the AIF with an agreed amount of investment on request by the AIFM.

Explanatory text

23. The terms set out in Box 94 are used in the advice provided by ESMA and therefore the definitions above have been included. ESMA considers that the following definitions are appropriate but it may be the case that additional guidelines are required if there are divergent interpretations of these terms.

24. The standard for considering positions in a netting arrangement is higher than that for considering positions in a hedging relationship. 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.

Proposed Advice

Box 95

Gross Method of Calculating the Exposure of the AIF

1. The exposure of an AIF calculated in accordance with the Gross Method is the sum of the absolute values of all its financial derivative instrument, non-financial-derivative instrument positions and other asset or liability positions calculated in accordance with Article 19 of Directive 2011/61/EU and its delegated acts, subject to the following criteria:

   (a) the value of any cash and cash equivalents which provide a return at the risk-free rate and are held in the base currency of the AIF should be excluded from the calculation;

   (b) financial derivative instruments should be converted into the market value of the equivalent underlying assets of that derivative;

   (c) liabilities that arise through cash borrowings where the amounts of that payable are known and exposed to insignificant market risks should be excluded from the calculation; and

   (d) positions within repurchase or reverse repurchase agreements should be included in the calculation in accordance with paragraph 10 and paragraph 11 of Box 98.

2. Borrowing arrangements entered into by the AIF are excluded if these are temporary in nature and relate to and are fully covered by capital commitments from investors.

3. To the extent that it is not included after considering paragraphs 1 and 2, exposure which is contained in any financial and/or legal structures involving third parties controlled by the relevant AIF should be included in the calculation of the exposure where the structures referred to are specifically set up to directly or indirectly increase the exposure at the level of the AIF. In particular, for private equity and venture capital funds this means that exposure that exists at the level of a portfolio company is not intended to be included when referring to such financial or legal structures and therefore should not be included in the calculation of the exposure of an AIF.[30]

Explanatory Text

25. ESMA recommends that all AIFM should be required to calculate exposure without considering netting or hedging arrangements and that the methods used to calculate exposure should be based on the CESR Guidelines. ESMA has chosen not to repeat the CESR Guidelines but provide principles on which the CESR Guidelines are based. ESMA considers that the following steps will be undertaken by AIFMs when calculating the exposure of the AIF in accordance with the advice and those Guidelines.

Steps

1. ESMA considers that all positions of the AIF should initially be included in the calculation of exposure at a value calculated in accordance with Article 19 AIFMD. This includes short and long assets and liabilities, borrowings, financial derivative instruments, repurchase and reverse repurchase transactions where the risks and rewards of the asset or liabilities are with the AIF and all other positions that make up the net asset value of the AIF.

[30] Recital 78 of post-jurist linguist text (ex recital 14)

2. Cash and cash equivalents in the base currency of the AIF which provide a return at the risk-free rate and which are ancillary to the investment strategy of the AIF should be removed from the calculation as they are not deemed to increase exposure. For the avoidance of doubt this may also include cash held for collateral by a counterparty. AIFM should use their judgement as to whether a position should be considered as cash or cash equivalent. ESMA advises that in general cash and cash equivalents comprise cash on hand and demand deposits, together with short-term, highly liquid investments that are readily convertible to a known amount of cash, and that are subject to an insignificant risk of changes in value. ESMA considers that in general an investment may meets the definition of a 'cash equivalent' when it has a maturity of three months or less from the date of acquisition. Equity investments are normally excluded, unless they are in substance a cash equivalent (e.g. preferred shares acquired within three months of their specified redemption date). Bank overdrafts which are repayable on demand and which form an integral part of an entity's cash management are also included as a component of cash and cash equivalents. Consistent with CESR's Guidelines on the calculation of global exposure, assets which provide a return at the risk-free rate are generally accepted as those which provide the return of short-dated (generally 3-month) high quality government bonds, for example 3-month US T-bills. Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions (commonly known as the 'Banking Consolidation Directive') furthermore contains a reference to the risk free rate.

3. Financial derivative instruments should be converted into the market value of the equivalent underlying position. ESMA considers that for AIFM to follow this requirement they would need to consider the conversion methods provided within the CESR Guidelines, for example, this would mean that options are delta adjusted[31].

4. So as to avoid double counting, borrowings that have been used to finance exposure should not be included within the calculation. ESMA considers that cash borrowings obtained through a bank or other counterparty would generally be excluded but ESMA also understands that other financial instruments could have the same effect as cash borrowing such as where an AIF has sold a bond short. AIFM should use their judgement and will need to consider whether the reasons for liability are solely financing or if they expect to make a gain through market movements of the liability. Where AIFM expect to make such a gain it is not expected that AIFM exclude these from the calculation of the exposure.

5. Borrowing arrangements entered into by the AIF are excluded if they are temporary in nature and relate to and are fully covered by capital commitments from investors. ESMA considers that only a limited number of investment strategies are arranged such that the AIF's liabilities in respect of temporary borrowing are guaranteed by capital commitments from investors. ESMA has concluded that it is not appropriate to define what is mean by 'temporary'. However, it is not the intention that AIFM include revolving credit facilities within this meaning.

6. If AIF are holding ordinary shares or shares in a target company or fund as an investment it is normally the case that the capital of the AIF that is at risk through this position is limited to the market value of those shares, this is similarly the case for a PE fund holding shares in a portfolio company. However this is no longer the case if the AIF has provided guarantees for any shortfall in the value of the property on which underlying loans in the portfolio company have been secured or where the loan is secured on property outside portfolio company structure i.e., cross-collateralisation. AIFM will need to include this incremental exposure in the calculation.

[31] Box 2 (pages 8-10) of the CESR Guidelines sets out the conversion methodologies for a non- exhaustive list of derivatives and when converting derivatives AIFM should make use of these guidelines. The term 'equivalent position' means that options should be delta adjusted because changes in the price movements of the underlying do not have a 1:1 relationship with the price movement of the options and therefore including the notional value of the option would not be the 'equivalent position'. The calculation of each financial derivative position should be converted to the base currency of the AIF using the spot rate.

26. ESMA considers that in interpreting the requirement in paragraph 3 of Box 95 in relation to financial and/or legal structures involving third parties controlled by an AIF it is important that there is as little scope as possible for regulatory arbitrage.

Proposed Advice

Box 96

Commitment Method of Calculating the Exposure of an AIF

1. The exposure of an AIF calculated in accordance with the Commitment Method is the sum of the absolute values of all its financial derivative instrument, non-financial derivative instrument positions and other asset or liability positions calculated in accordance with Article 19 of Directive 2011/61/EU and its delegated acts, subject to the following criteria:

   (a) cash and cash equivalent positions, financial derivative instruments, liabilities that arise through cash borrowing and positions within repurchase or reverse repurchase agreements are subject to the adjustments in paragraph 1(a)-(d) of Box 95;
   (b) positions which are deemed to be in hedging arrangements in accordance with Box 94 which satisfy the conditions in paragraph 2 should not be included in the calculation;
   (c) positions which are deemed to be in netting arrangements in accordance with Box 94 which satisfy the requirements of paragraph 4 should be included at their total combined net exposure.

2. Hedging arrangements may only be taken into account when calculating the exposure of an AIF if they comply with all the criteria below:

   (a) the positions involved within the hedging relationship do not aim to generate a return;

   (b) there should be a verifiable reduction of market risk at the level of the AIF;

   (c) the risks linked to financial derivative instruments, i.e., general and specific, if any, should be offset;

   (d) the hedging arrangements should relate to the same asset class; and

   (e) they should be efficient in stressed market conditions.

3. Notwithstanding paragraph 2, financial derivative instruments used for currency hedging purposes (i.e. that do not add any incremental exposure, leverage and/or other market risks) should not be included in the calculation.

4. An AIFM may net positions:

   (a) between financial derivative instruments, provided they refer to the same underlying asset, even if the maturity date of the financial derivative instruments is different; or

   (b) between a financial derivative instrument whose underlying asset is a transferable security, money market instrument or units in collective investment undertaking as defined in point 1 to 3 of Section C of Annex I of Directive 2004/39/EC and that same corresponding underlying asset.

5. AIFM that manage AIF that, in accordance with their core investment policy, primarily invest in

interest rate derivatives may make use of specific duration netting rules in order to take into account the correlation between the maturity segments of the interest rate curve.

6. Borrowing arrangements entered into by the AIF and exposure contained in financial and/or legal structures involving third parties controlled by the relevant AIF should be subject to the adjustments in paragraph 2 and 3 of Box 95.

7. To the extent that it is not included after considering paragraphs 1 and 2 exposure which is contained in any financial and/or legal structures involving third parties controlled by the relevant AIF should be included in the calculation of the exposure where the structures referred to are specifically set up to directly or indirectly increase the exposure at the level of the AIF. In particular for private equity and venture capital funds this means that exposure that exists at the level of a portfolio company is not intended to be included when referring to such financial or legal structures and therefore should not be included in the calculation of the exposure of an AIF.

Explanatory Text

27. ESMA recommends that in addition to calculating exposure using the Gross Method all AIFM must calculate exposure using the Commitment Method. This means they may consider netting and hedging relationships that reduce the exposure of an AIF where they meet specific criteria. This approach builds on the Gross Method set out above and therefore the explanatory text focuses on the netting and hedging arrangements that may be considered in reducing the exposure of the AIF.

28. Hedging arrangements may only be taken into account when calculating the exposure of an AIF if they comply with all the criteria below:

- the positions involved within the hedging relationship do not aim to generate a return;
- there should be a verifiable reduction of market risk at the AIF level;
- the risks linked to financial derivative instruments, i.e., general and specific if any, should be offset;
- the arrangements should relate to the same asset class; and
- the arrangements should be efficient in stressed market conditions.

29. An AIFM may net positions:

- between financial derivative instruments, provided they refer to the same underlying asset, even if the maturity date of the financial derivative instruments is different; and
- between a financial derivative instrument whose underlying asset is a transferable security, money market instrument or units in collective investment undertaking as defined in point 1 to 3 of Section C of Annex I of Directive 2004/39/EC and that same corresponding underlying asset.

30. AIFM that manage AIF investing primarily in interest rate derivatives may, in relation only to that AIF, make use of specific duration netting rules in order to take into account the correlation between the maturity segments of the interest rate curve.

Netting

31. The requirement that netting arrangements should refer to the same underlying asset should be interpreted strictly: assets which the AIFM considers as equivalent or highly correlated, such as different share classes or bonds issued by the same issuer, should not be considered as identical for the purpose of netting arrangements.

32. The definition of netting arrangements aims to ensure that only those trades which offset the risks linked to other trades, leaving no material residual risk, are taken into account. This means that combinations of trades which aim to generate a return, however small, by reducing some risks but keeping others should not be considered as netting arrangements. This is the case, for example, with arbitrage investment strategies which aim to generate a return by taking advantage of pricing discrepancies between financial derivative instruments with the same underlying but different maturities.

33. It is possible to net a call option on share xyz with a 3-month maturity with a put option on that same share xyz with a 6-month maturity. The global exposure on the residual position on these two options is equal to the (absolute value of the) sum of the exposure on the call option (which is positive) and on the put option (which is negative).

34. It is possible to net a long position on share xyz with a put option on that same share xyz.

Hedging

35. The scope of hedging arrangements as defined in the CESR Guidelines is much narrower than that of strategies which may commonly be referred to as hedging strategies.

36. The following list illustrates situations where the hedging strategy may comply with the above criteria:

- A portfolio management practice which aims to reduce the duration risk by combining an investment in a long-dated bond with an interest rate swap or to reduce the duration of an AIF bond portfolio by concluding a short position on bond future contracts representative of the interest rate risk of the portfolio (duration hedging).

- A portfolio management practice which aims to offset the significant risks linked to an investment in a well diversified portfolio of shares by taking a short position on a stock market index future, where the composition of the equity portfolio is very close to that of the stock market index and its return highly correlated to that of the stock market index and where the short position on the stock market index future allows for an unquestionable reduction of the general market risk related to the equity portfolio (beta-hedging of a well diversified equity portfolio where the specific risk is considered to be insignificant).

- A portfolio management practice which aims to offset the risk linked to an investment in a fixed interest rate bond by combining a long position on a credit default swap and an interest rate swap which swaps that fixed interest rate with an interest rate equal to an appropriate money market reference rate (for example, EONIA[32]) plus a spread. Such a strategy might be considered as a hedging strategy as all the hedging criteria laid down above are in principle complied with.

[32] Euro OverNight Index Average

37. The following list illustrates situations which do not comply with the hedging criteria:

- A portfolio management practice which aims to offset the risk of a given share by taking a short position through a derivative contract on a share that is different but strongly correlated with that first share. Though this strategy relies on taking opposite positions on the same asset class, it does not hedge the specific risk linked to the investment in share x. It should not be considered as a hedging strategy as laid down under point 1 of Box 8 as criteria (a), (b) and (c) in particular are not complied with.

- A portfolio management practice which aims to keep the alpha of a basket of shares (comprising a limited number of shares) by combining the investment in that basket of shares with a beta-adjusted short position on a future on a stock market index. This strategy does not aim to offset the significant risks linked to the investment in that basket of shares but to offset the beta (market risk) of that investment and keep the alpha. The alpha component of the basket of shares may dominate over the beta component and as such lead to losses at the level of the AIF, For that reason, it should not be considered as a hedging strategy as laid down under point 1 of Box 95 above, as criteria (a) and (b) in particular are not complied with.

- A merger arbitrage strategy: such a strategy combines a synthetic short position on a stock with a long position (synthetic or not) on another stock.

- As in the previous example, such a strategy aims to hedge the beta (market risk) of the positions and generate a return linked to the relative performance of both stocks. Similarly, the alpha component of the basket of shares may dominate over the beta component and as such lead to losses at the level of the AIF. It should not be considered as a hedging strategy as laid down under point 1 of Box 95, as criteria (a), (b) and (c) in particular are not complied with.

- A strategy which aims to hedge a long stock position with purchased credit bond protection (CDS) on the same issuer. This strategy relates to two different asset classes and cannot be taken into account for the purpose of calculating the global exposure as criterion (d), *inter alia*, as laid down under point 10 of Box 93 above, is not complied with.

Proposed Advice

Box 97

Advanced Method of Calculating the Exposure of an AIF

1. An AIFM, having notified the competent authorities of its home Member State in accordance with Box 93, must calculate the exposure of an AIF it manages in accordance with the Advanced Method for all of the assets of the AIF on the basis of the requirements below:

   (a) take into account paragraph 3 of Box 95;

   (b) calculate exposure for each financial derivative instrument position with reference to the Commitment Method in accordance with Box 96 where that calculation provides a meaningful result;

   (c) in all other cases, the AIFM should employ a calculation method that it considers will result in an appropriate approximation of the AIF's exposure, which may include the estimated maximum loss;

   (d) offsetting arrangements may be taken into account in relation to all assets if they offset risks

linked to all or part of an asset or liability of the AIF and the following conditions are satisfied:

(i) the AIFM can demonstrate that the arrangements are likely to remain materially effective in times of stressed market conditions; and
(ii) there is a verifiable reduction in risk at the level of the AIF;

2. In calculating the exposure of an AIF under the Advanced Method the AIFM should always take into account the following principles:

(a) the methodology should be fair, conservative and not underestimate nor give a misleading view to investors of the exposure of the AIF;

(b) the approach must be consistently applied over time and where applicable, between AIFs; and

(c) the AIFM should demonstrate that the calculation method employed in accordance with paragraph 1(b) and the positions that are offset in accordance with paragraph 1(c) are consistent with how the AIFM manages risk within that AIF.

Explanatory Text

38. AIFM may, upon the required notification to their competent authority, use the Advanced Method for the calculation of the exposure of the AIF. ESMA considers that this approach should solve the two issues of the Commitment Method:

- Restrictive netting and hedging rules: The Advanced Method relaxes the Commitment Method's requirements in relation to netting and hedging, specifically it permits positions to be offset even where they are conducted with the aim of generating a return and the arrangements do not need to relate to the same asset class.
- Exposure is not representative of the loss boundaries for certain positions or groups of positions: positions that are delta-adjusted may overstate the maximum losses on that position or group of positions and therefore AIFM may use a different methodology when calculating the exposure for these positions.

39. Although the Commitment Method is relaxed in relation to the above two cases, the AIFM must always take into account the principles set out in paragraph 2 when applying the Advanced Method. In order to ensure that approximations used in the Advanced Method fully reflect the level of the AIF's exposure to market risk the AIFM may also incorporate elements of the Commitment Method, for example, by excluding from the calculation certain cash borrowings and cash or cash equivalents which provide a return at the risk free rate.

40. It is expected that many of the examples presented in the Explanatory Text to the Commitment Method may now be considered to reduce the exposure of the AIF if they can fulfil these conditions.

Proposed Advice

Box 98

Methods of Increasing the Exposure of an AIF

When calculating exposure, AIFM should take into account the following non-exhaustive methods.

1. **Unsecured Cash borrowings:** When cash borrowings are invested they have the propensity

to increase the exposure of the AIF by the total amount of those borrowings. If cash borrowings of €100m were used to purchase securities of the same value there is the possibility that the value of the securities could fall to €- with the result that the AIF would be exposed to the full €100m. However, if the cash borrowings are not invested but remain in cash or cash equivalents which remain the base currency of the AIF they will not increase the exposure of the AIF.

2. **Secured Cash Borrowings:** Similar to the above but the loan may be secured by a pool of assets or a single asset. If the cash borrowings are not invested but remain in cash in the base currency of the AIF they will not increase the exposure of the AIF.

3. **Convertible borrowings**: purchased debt which has the ability, under certain circumstances, to enable the holder or issuer to convert that debt into another asset. The exposure of the AIF is the market value of such borrowings.

4. **Interest rate swaps:** An interest rate swap is an agreement to exchange interest rate cash flows, calculated on a notional principal amount, at specified intervals (payment dates) during the life of the agreement. Each party's payment obligation is computed using a different interest rate based on the notional exposures.

5. **Contracts for Differences:** CFD is an agreement between two parties – the investor and the CFD provider – to pay the other the change in the price of an underlying asset. Depending on which way the price moves, one party pays the other the difference from the time the contract was agreed to the point where it ends. Exposure is the market value of the underlying asset.

6. **Futures contracts:** An agreement to buy or sell a stated amount of a security, currency, commodity, index or other asset at a specific future date and at a pre-agreed price. The exposure is the market value of the equivalent underlying asset.

7. **Total Return Swaps**: A total return swap is an agreement in which one party (total return payer) transfers the total economic performance of a reference obligation to the other party (total return receiver). Total economic performance includes income from interest and fees, gains or losses from market movements, and credit losses. The exposure of the AIF is the market value of the equivalent reference assets which have a bearing of the economic performance of the swap.

8. **Forward agreements**: A forward is a customized, bilateral agreement to exchange an asset or cash flows at a specified future settlement date at a forward price agreed on the trade date. One party to the forward is the buyer (long), who agrees to pay the forward price on the settlement date; the other is the seller (short), who agrees to receive the forward price. Entering into a forward contract typically does not require the payment of a fee. The exposure of the AIF is the notional value of the contract.

9. **Options**: 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. The boundaries of the exposure of the fund will be between a potential unlimited exposure to an exposure that is limited to the higher of the premium paid or the market value of that option. To get to the point between these two bounds the exposure is the delta (Options Delta measures the sensitivity of an option's price solely to a change in the price of the underlying asset) adjusted equivalent of the underlying position.

10. **Repurchase agreements:** This transaction normally occurs where an AIF 'sells' securities to a reverse-repo counterparty and agrees to buy them back at an agreed price in the future. The AIF will incur a financing cost from engaging in this transaction and therefore will need to re-invest the cash proceeds (effectively cash collateral) in financial instruments that provide a return greater than the financing cost incurred. This reinvestment of 'cash collateral' means that incre-

mental market risk will be carried by the AIF and so must be taken into account in the global exposure calculation. It is important to note that the economic risks and rewards of the 'sold' securities remain with the AIF. It is also worth noting that a repo transaction will almost always give rise to leverage as the cash collateral must be reinvested at a yield greater than the financing costs incurred in order for the AIF to make a return. In the event that non-cash collateral is received as part of the transaction and this collateral is further used as part of another repo, or stock-loan agreement, the full market value of the collateral must be included in the global exposure amount. The exposure of the AIF is increased by the reinvested part of the cash collateral.

11. **Reverse repurchase agreements:** This transaction occurs where an AIF 'purchases' securities from a repo counterparty and agrees to sell them back at an agreed price in the future. AIF normally engage in these transactions to generate a low-risk money-market type return, and the 'purchased' securities act as collateral. Therefore no global exposure is generated and nor does the AIF take on the risks and rewards of the 'purchased' securities, i.e., there is no incremental market risk. However, it is possible for the 'purchased' securities to be further used as part of a repo or stock-loan transaction, as described above, and in that case the full market value of the securities must be included in the global exposure amount. The economic risks and rewards of the purchased securities remain with the counterparty and therefore this does not increase the exposure of the AIF.

12. **Securities lending arrangements:** An AIF engaging in a securities lending transaction will lend stock to a stock-borrowing counterparty (who will normally borrow stock to cover a physical short sale transaction) for an agreed fee. The stock borrower will deliver either cash or non-cash collateral to the AIF. Only where cash collateral is reinvested in instruments that provide a return greater than the 'risk-free rate' will global exposure be created. If the non-cash collateral is further used as part of a repo or another stock lending transaction, the full market value of the securities must be included in the global exposure amount as described above. Exposure is created to the extent that the cash collateral has been reinvested.

13. **Securities borrowing arrangements**: An AIF engaging in the borrowing of stocks will borrow stock from a stock-lending counterparty for an agreed fee. The AIF will then sell the stock in the market. The AIF is now short that stock. To the extent that the cash proceeds from the sale are reinvested this will also increase the exposure of the AIF. Exposure is the market value of the shorted stocks; additional exposure is created to the extent that that cash received is reinvests.

Explanatory Text

41. In the request for advice provided by the Commission, ESMA was requested to outline the methods that could be used to increase the exposure of an AIF. It remains a considerable challenge to comprehensively identify all these methods and therefore ESMA has provided an indicative list. In general there are some general principles that have been applied:

- AIFM should consider the substance of the transaction in addition to its legal form. Specifically with respect to repurchase transactions the AIFM should consider if the risks and rewards of the assets involved are passed or retained by the AIF.

- AIFM should in general look through financial derivative instruments or other contractual arrangements to the underlying assets to determine the possible future commitments of the AIF resulting from that transaction.

- Borrowing does not necessarily increase the exposure of the AIF if the amounts borrowed are not reinvested in assets that provide risk free returns. Including such borrowing would double count the exposure of an AIF.

Proposed Advice

Box 99

Exposures involving third party legal structures

Recital 78 of the AIFMD refers to '...any financial and/or legal structures involving third parties controlled by the relevant AIF, where the structures referred to are structures specifically set up to directly or indirectly create leverage at the level of the AIF. In particular for private equity and venture capital funds this means that, leverage that exists at the level of a portfolio company is not intended to be included when referring to such financial or legal structures'. ESMA is consulting on three options to assist firms when interpreting these requirements.

Option 1

AIFMs shall include in the calculation of leverage any exposure which is contained within financial and/or legal structures involving third parties to the extent that entities involved within those structures have recourse to the AIF via cross-collateralisation or guarantees, including guarantees, where there is an expectation that the AIF will contribute to the underlying structure even through there is no legally enforceable obligation.

Option 2

AIFMs shall include in the calculation of leverage any exposure which is contained within financial and/or legal structures involving third parties to the extent that entities involved within those structures are non-listed companies or issuers controlled by the AIFM within the scope of Article 26 and have recourse to the AIF via cross-collateralisation or guarantees, including guarantees, where there is an expectation that the AIF will contribute to the underlying structure even though there is no legally enforceable obligation.

Option 3

AIFMs shall not include in the calculation of leverage any exposure which is contained within financial and/or legal structures involving third parties to the extent that the AIF is holding ordinary shares, shares in a target company or shares or units in a collective investment undertaking as an investment and the capital of the AIF that is at risk through this position is limited to the market value of those shares or units. However, AIFMs shall include in the calculation of leverage any exposure which is contained within financial and/or legal structures involving third parties to the extent that the AIF has provided guarantees for any shortfall in the value of the property relating to the underlying shares or units have been secured or where a loan has been secured on property relating to the underlying shares or units outside of a portfolio company structure by way of cross-collateralisation.

Explanatory Text

42. There are three options under consideration for ESMA's advice in relation to further articulating how recital 78 should be applied by AIFMs when calculating leverage.

43. Option 1 and 2 both provide a high level statement that AIFM should look through these financial and/or legal structures but only include in the leverage calculation that additional exposure which result from cross collateralisation or guarantees. However, option 2 limits the scope of this provision to

non-listed companies or issuers over which an AIFM has control, which mainly applies to private equity, venture capital and real estate funds.

44. Option 3 is more specific and suggests that in general the exposure obtained by investing in ordinary shares, shares in a target company and shares in investment funds will not go beyond the market value of those shares unless the AIF has providing guarantees to entities within that structure.

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

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

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

Q58: Do you agree that when an AIFM calculates the exposure according to the gross method as described in Box 95, cash and cash-equivalent positions which provide a return at the risk-free rate and are held in the base currency of the AIF should be excluded?

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

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

VII. Possible Implementing Measures on Limits to Leverage or Other Restrictions on the Management of AIF

The supervisory context of the Directive's Article 25(3) powers

1. Article 25(3) of the AIFM Directive requires competent authorities, under certain conditions and according to specified procedures, to exercise supervisory powers to 'impose limits on the level of leverage that AIFM are entitled to employ or other restrictions on the management of the AIF with respect to the AIFs 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'.

2. In considering its advice in relation to Article 25(3), ESMA has taken into account the new macro-prudential framework which is part of the European System for Financial Supervision (ESFS) which became effective on 1 January 2011. A competent authority's powers under Article 25(3) to intervene in the use of leverage by AIFM operate within this new supervisory system, forming part of what are ongoing supervisory processes and systemic risk assessments of AIFM by competent authorities and the European Supervisory Authorities, with reference to the stability and integrity of the financial system.

3. Certain respondents to the call for evidence expressed a view that the intervention powers foreseen in Art. 25(3) should be limited to exceptional circumstances and called on ESMA to develop clear criteria for the exercise of these powers and to engage in a continuous exchange of views in order to fulfil the co-ordination and facilitation role envisaged under Art. 25(5). Some respondents also set out a number of arguments explaining that AIFs generally do not pose systemic risk and that efforts to mitigate risks arising from leverage would be more appropriately directed towards leverage providers/lenders.

4. Several respondents requested that ESMA's advice take into account IOSCO's principles for hedge funds and recognise that investors' interests could be harmed by any decision to require an AIF to deleverage within a short period of time; in their view, better disclosure and appropriate internal controls (including of conflicts of interest) were the solution. Certain respondents agreed with this point, stating that the AIFM should be allowed to reduce positions within a reasonable period of time and in way that is consistent with the investors' best interests.

5. Some respondents also saw merit in establishing a transparent procedure in the context of leverage limits, which could consist of several stages i.e. a warning by the relevant competent authority followed by an opportunity for the AIF to explain and demonstrate its proposed approach to addressing the excessive leverage.

6. ESMA notes that the assessment of the use of leverage by an AIFM begins from the outset of its authorisation i.e. from the time of receipt of an AIFM's authorisation application under Article 7(3)(a) and Article 8 of the Directive. An AIFM must in accordance with Article 15(4) of the Directive, set a maximum level of leverage which that AIFM may employ for each AIF, and this must take into account, inter alia, the sources of leverage and any other linkages or relationships the AIFM has with other financial institutions that could themselves pose systemic risk.

7. More generally in relation to competent authority oversight of use of leverage, ESMA has noted that the Directive requires that AIFM employing leverage on a substantial basis must make available to their

home competent authorities detailed information concerning the overall level of leverage, cash and securities borrowing, and leverage in its financial derivatives, also identifying to their home competent authority their five largest sources of borrowed cash or securities[33]. These reporting requirements in relation to leverage are discussed in Boxes 109 (Format and Content of Reporting to Competent Authorities) and 110 (Use of Leverage on a Substantial Basis). ESMA has also noted that competent authorities may require additional information of an AIFM on an ad hoc or periodic basis where necessary for the effective monitoring of systemic risk. Exceptionally, ESMA may require this of competent authorities where it appears necessary for the effective monitoring of systemic risk[34].

8. ESMA notes further that competent authorities receiving information under Articles 24(4) & 24(5) must use it in order to identify the extent to which use of leverage by AIFM is contributing 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[35].

9. ESMA is also aware that the ESFS and EU-wide supervisory cooperation are relevant to regulatory oversight of the use of leverage by AIFM: the systemic risk information obtained under Articles 24(4) and 24(5) must be made available to fellow EU competent authorities, to ESMA and the European Systemic Risk Board[36]. Against this macro-regulatory backdrop ESMA may also determine that where the leverage employed by an AIFM or a group of AIFM poses or pose substantial risk to the stability and integrity of the financial system, it may issue advice to a competent authority specifying any appropriate remedial action to be taken[37].

Level 1 text: Article 25 (3)

The AIFM shall demonstrate that the leverage limits set by it for each AIF it manages are reasonable and that it complies with those limits at all times. The competent authorities shall assess the risks that the use of leverage by an AIFM with respect to the AIFs it manages could entail, and, where 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, shall impose limits to the level of leverage that an AIFM is entitled to employ or other restrictions on the management of the AIF with respect to the AIFs 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 shall duly inform ESMA, the ESRB and the competent authorities of the AIF, of actions taken in this respect, through the procedures set out in Article 50.

Scope of the Commission's implementing powers

The Commission shall adopt by means of delegated acts, in accordance with Article 56 and subject to the conditions of Articles 57 and 58, measures setting out principles specifying the circumstances in which competent authorities apply the provisions set out in paragraph 3, taking into account different strategies of AIFs, different market conditions in which AIFs operate and possible pro-cyclical effects of applying those provisions.

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[33] Article 24(4)
[34] Article 24(5)
[35] Article 25(1)
[36] Articles 25(2) and 53(1)
[37] Article 25(7)

The Commission's Request for Advice to ESMA (CESR)

The Directive requires the Commission to adopt measures by means of delegated act(s) 'setting out the *principles specifying the circumstances in which competent authorities apply*' their supervisory powers under Article 25(3), taking account of different AIF strategies, different market conditions in which AIFs operate and possible pro-cyclical effects following from exercising the provisions.[38]

In its request to ESMA, the Commission noted that these principles should guide competent authorities in identifying situations and circumstances in which they shall exercise the Article 25(3) powers to limit the extent to which the use of leverage by AIFM contributes to systemic risk in the financial system or risks disorderly markets.

In preparing its draft advice in relation to the principles which should determine a competent authority's use of the Article 25(3) powers, ESMA has been requested to consider, *inter alia*, to what extent certain considerations might endanger the stability and integrity of the financial system. These considerations are:

- leverage used in different strategies and the size of an AIF's 'footprints';
- the concentration of risks in particular markets and risks of spill-over effects;
- liquidity issues in particular markets;
- counterparty risks to credit institutions or other systemically relevant institutions;
- the scale of any asset/liability mismatch; and
- the evolution of prices of assets with respect to their fundamentals.

ESMA has also been requested to advise the Commission on the appropriate timing of potential measures referred to in Article 25(3).

Proposed Advice

Box 100

Principles specifying the circumstances under which competent authorities will exercise the powers to impose leverage limits or other restrictions on AIFM

1. The competent authorities of the home Member State of the AIFM shall assess the risks that the use of leverage by an AIFM with respect to the AIFs it manages, could entail, with reference to the information provided under Articles 7 (3), 15(4) and/or reported under Article 24(4) and/or 24(5) of Directive 2011/61/EU.

2. The assessment by the competent authorities in paragraph 1 shall have regard to the extent to which the use of leverage by an AIFM, or by a group of AIFMs, could contribute to the build-up of systemic risk in the financial system, or risks creating disorderly markets.

3. If, following such assessment, the competent authorities deem it necessary to ensure the stability and integrity of the financial system, after following the required notification procedures in Arti-

[38] Article 25(9)

cles 25(3) and 25(4), they shall impose limits or other appropriate supervisory restrictions on the use of leverage by such AIFM[39].

4. The following illustrative circumstances and criteria should guide the assessment undertaken by competent authorities under above Principles 1-3 to ensure the stability and integrity of the financial system:

   (a) Circumstances where the exposures of an AIF, or group of AIF, arising through the use of leverage by an AIFM, including those exposures resulting from financing or investment positions entered into by the AIFM, or by the AIFM on behalf of the AIF, could constitute an important source of market, liquidity, or counterparty risk to a financial institution, in particular, to any such institution the competent authority deems to be systemically relevant.

   (b) Circumstances where the activities of AIFM, or group of AIFM, in particular with reference to the types of assets in which the AIF invests and the techniques employed by the AIFM, or group of AIFM, through the use of leverage, contribute or may contribute to the downward spiral in the prices of financial instruments, or other assets, in a manner which threatens the viability of such financial instruments or other assets.

   (c) Criteria such as the type of AIF under management, the investment strategy of the AIFM, or group of AIFM, in relation to the AIF concerned, the market conditions in which the AIFM and the AIF operate, and any likely pro-cyclical effects which may result from the imposition by the competent authorities of limits or other restrictions on the use of leverage by the AIFM or group of AIFM concerned.

   (d) Criteria such as the size of an AIF or group of AIFs and any related impact in a particular market sector, any concentration of risks in particular markets in which an AIF or group of AIFs are invested, any contagion risk to other markets from a market where risks have been identified, any liquidity issues in particular market or sector at a given time, the scale of any asset/liability mismatch in a particular AIFM investment strategy, or any irregular evolution of prices of assets in which an AIF may be invested.

5. Competent authorities of the home Member State of the AIFM concerned shall determine the appropriate timing of any potential measures under Article 25(3) having regard to the need to avoid or minimise, as the case may be, any identified risks, including systemic risk. The timing of any such measures shall take into account the nature of the risk and degree of any likely impact on the stability and integrity of the financial system.

Explanatory Text

Proposed principles

10. For the purposes of advising the Commission on the *principles specifying the circumstances in which competent authorities must exercise their article 25(3) powers*, ESMA believes it would be useful to capture, in these principles, the supervisory framework within which competent authorities will exercise their supervisory powers to intervene in use of leverage by AIFM.

11. ESMA's proposed advice to the Commission is accordingly that the first of these principles should embody the distinct supervisory processes contained within Article 25(3) (and other leverage-relevant provisions in the Directive) framing the intended intervention in the use of leverage, or the imposition of other supervisory measures. These processes are that:

[39] ESMA notes that under Article 25(2) competent authorities shall share with each other information which they gather from AIFM under Article 24, including information in relation to AIFM managing AIFs employing leverage on a substantial basis.

(i) AIFM must demonstrate to their home competent authorities that the leverage limits the AIFM have put in place for each AIF they manage, are reasonable and that they comply with such limits.

(ii) Competent authorities must separately assess the risks that the use of leverage by AIFM for AIF under management could entail.

(iii) Following (ii) above, where competent authorities deem it necessary to ensure the stability and integrity of the financial system, after having notified ESMA, the ESRB and the competent authorities of the relevant AIF, they must impose limits to leverage employed by an AIFM, or other restrictions in the management of an AIF to limit the extent to which use of leverage by AIFM contributes to the build-up of systemic risk in the financial system, or risks disorderly markets.

(iv) The competent authority of the home Member State of the AIFM must inform ESMA and the ESRB (and, as the case may be, the competent authorities of the AIF) of 'actions taken in this respect' through the supervisory cooperation procedures in Article 50 of the Directive.

12. Principles 1-4 in Box 100 set out the supervisory processes underpinning Article 25(3). More particularly, Principles 1-3 set out the framework under which competent authorities should consider the use of leverage by AIFM with regard to the criteria set out in Article 25(3) i.e. the extent to which the use of leverage by AIFM contributes to the build-up of systemic risk or risks of disorderly markets.

13. ESMA believes that an additional principle, Principle 4, is needed in the Commission measures to guide competent authorities in identifying, non-exhaustively, situations which might pose systemic risk or market disorder of some kind. ESMA believes that the guidance in Principle 4 should also cover the examples listed in the Commission's request in relation to Issue 23, to assist competent authorities further in forming a judgment whether intervention to impose limits on the use of leverage by AIFM, or group of AIFM, or other restrictions on the management of AIF, is appropriate and justified under Article 25(3). Principle 4 of ESMA's advice therefore sets out the circumstances, criteria and likely possible scenarios which should guide a competent authority's assessment and judgement whether or not intervention is appropriate. These circumstances and criteria are intended to be illustrative rather than exhaustive.

Appropriate timing of potential Article 25(3) measures

14. ESMA has also been requested to advise the Commission on the appropriate timing of any potential measures imposed by competent authorities under Article 25(3).

15. ESMA believes that it is not appropriate to set any strict or pre-determined timeframes or rules identifying or pinpointing the precise timing of any supervisory intervention by competent authorities in relation to the use of leverage by AIFM. Any such timeframes or rules could fetter the regulatory judgment of competent authorities, and potentially risk reducing the effectiveness or proportionality of any appropriate supervisory measures to be imposed on AIFM. ESMA considers that the question of appropriate timing for the imposition of measures should be a matter for the judgment of competent authorities in each case. It also believes that the competent authority's judgment on appropriate timing should be determined with reference to avoiding or minimising any potential manifestation of systemic risk, with the principal objective of maintaining the stability and integrity of the financial system.

16. In addition, ESMA acknowledges that any competent authority judgment relating to the appropriate timing for the imposition of leverage limits or other restrictions on AIFM must take into account the notification procedures in Article 25(2) and Article 25(4), as well as the supervisory co-operation processes which operate by virtue of the ESFS.

17. ESMA's views on the approach to the timing of any supervisory measures are set out in Principle 5 of our proposed advice.

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

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

VIII. Transparency Requirements

1. One of the main objectives of the Directive is to increase the transparency of AIFMs vis-à-vis investors and competent authorities. The financial crisis has highlighted the range of risks to which investors in investment funds are exposed. The Directive introduces safeguards to ensure that investors in alternative investment funds are well informed and adequately protected. To that end, the Directive lays down requirements regarding:

   - the annual report of the AIF;
   - disclosure to investors before they invest into the AIF as well as on a periodic basis thereafter; and
   - reporting to competent authorities.

2. The IASB identifies the objective of financial statements as being the provision of '*information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions.*'[40] While noting that financial statements provide information about management's stewardship of an entity's resources the Framework explains that information about an entity's financial position, performance and changes in financial position assists users in taking forward looking economic decisions. With the increasing international nature of investment investors need to have accounting information that they can understand when making investment decisions. As a result the measures proposed by ESMA in relation to the annual report combines minimum requirements which reflect recognised 'best practices' with the application of relevant accounting standards and rules.

3. To improve investor protection, the Directive provides for a number of requirements to enhance transparency which include specific disclosure requirements to potential investors ahead of investment, including performance data and net asset values, ongoing disclosure on areas such as liquidity, risk management and leverage to existing investors and the provision of annual audited accounts to investors and the competent authorities of the home Member State of the AIFM, and, where applicable the home Member State of the AIF.

4. Since the activities of AIFMs can have effects across borders and on financial actors around them, it seems appropriate that regulators should monitor these entities in a similar manner to how they monitor other financial institutions. The increased transparency achieved through the provisions on reporting to competent authorities should make it easier for regulators to detect and respond to risks in the relevant markets. However it is important that data is only collected where competent authorities have identified a clear use for it in mitigating a particular risk and as a result the proposed frequency of reporting has been determined as a function of the potential risks posed by specific types of AIFM.

5. The Directive envisages several Level 2 measures to further specify these transparency requirements which have been set out in sections VIII.I to VIII.III of this paper.

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[40] The Framework for the Preparation and Presentation of Financial Statements, paragraph 12

VIII.I. Possible Implementing Measures on Annual Reporting

1. ESMA has been requested to advise the Commission on the content and format of the Directive's annual reporting provisions. ESMA has been asked to cover quite specific information in relation to the content and format of the balance sheet (or statement of assets and liabilities), the income and expenditure account and the report on activities of the financial year. ESMA notes that this information should cover with some specificity the appropriate presentation, elements and level of detail of the AIF's assets, liabilities, net assets (shareholders or unit holders' equity), and the statement of cash inflows to and outflows from the AIF.

2. ESMA has also been requested to advise on how material changes in the information listed in Article 23 (Disclosure to Investors) should best be presented in an AIF's annual report, and on the content and the format of the remuneration disclosure required under Article 22(2)(e) and (f), including details on the form of remuneration.

3. Some respondents to the call for evidence stressed that the presentation and content of financial statements was a matter to be governed by accounting standards and that it should be clear that any additional content was not part of the financial statements. Several respondents also suggested that the elements and level of detail for the assets, liabilities, net assets (shareholders' equity) and cash inflows and outflows that should be included in the AIF annual report should include all significant assets and liabilities as separate line items.

4. Several respondents to the call for evidence asked ESMA to take account of the requirements of the UCITS Directive. It was also pointed out that the framework should be sufficiently flexible so as not to constitute a de facto barrier to entry for non-EU AIFs once the passport was introduced.

5. ESMA is aware that there have been major changes in financial reporting, internationally, in recent years. One of the most significant changes has been the convergence around international financial reporting standards (IFRS). In many countries 'national GAAP' is gradually being supplemented or replaced by the use of IFRS. However, the extent of this currently varies from country to country, and there are several countries where 'national GAAP' is tailored to provide specific and appropriate rules for investment companies whilst IFRS currently remains at a more general level. For example, the USA is engaged in a significant programme of work with the IASB to converge IFRS and US GAAP. As a result US GAAP is a major influence on the way in which IFRS is developing across international jurisdictions generally which is likely to lead over time to further harmonisation, with appropriate financial reporting requirements for investment companies.

6. ESMA's advice recognises that there are national and international accounting standards in place that set out prescriptive rules in this area. As a result ESMA has sought to set out a framework that will take account of and work in parallel with existing national and international requirements, where applicable, without cutting across them. As a result ESMA considers it important that the Commission's measures to be adopted via delegated acts on the Directive's annual reporting provisions should provide for high-level principles to be applied proportionately to AIF. While these principles will have general relevance for all AIF, they should be sufficiently flexible to allow for differentiated and proportionate application when taking account of the nature, scale and complexity of an AIFM's business, including the nature and size of the AIF it manages. ESMA's approach is accordingly in line

with Article 22(4) of the Directive, which recognises that such measures should be adapted to the type of AIF to which they are sought to be applied.

7. ESMA's advice therefore purposively and intentionally seeks to avoid an approach of applying rigid rules or templates, providing instead minimum but nonetheless proportionate requirements which reflect recognised 'best practices', including key elements of financial statements, and a non-exhaustive list of underlying line items, with the approach of applying relevant accounting standards and rules. This approach also takes account of the operation of international and national rules and standards in this area, and acknowledges the diversity of the AIF population.

8. Article 22(2) read with Article 60 of the Directive provides that there are certain minimum standards to be met and as a result ESMA believes the proposed approach is consistent with the Directive. ESMA has also noted that in Article 22(3) the Directive permits Member States a derogation to allow AIFM marketing non-EU AIF to subject the annual reports of such AIF to an audit meeting international auditing standards in force in the country where such AIF are established.

9. On this basis, while some general requirements for all AIF may be necessary, the requirements should be adaptable to reflect the diversity, size and structures of AIF, and to the nature and business models of the AIF under management. Due to their general nature, these requirements may be calibrated in an appropriate, differentiated and proportionate manner, reflecting the specific characteristics including legal structure, applicable Union and national legislation, and adopted accounting standards or rules of the AIF.

10. ESMA draws the Commission's attention to the required scope of the implementing measures for Article 22. The proposed advice in Boxes 101 to 106 should cover all EU AIFMs and those non-EU AIFMs marketing AIFs in a Member State territory only under private placement and without an EU marketing passport[41]. The implementing measures to be adopted by the Commission for Article 22 should also exclude from their scope EU AIFMs managing but not marketing non-EU AIFs in Member States[42].

Scope of the Commission's implementing powers

'*The Commission shall adopt by means of delegated acts, in accordance with Article 56, and subject to the conditions laid down in Articles 57 and 58, measures specifying the content and format of the annual report. Those measures shall be adapted to the type of AIF to which they apply.*'

Extract from Level 1 text - Article 22 (2)

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;

[41] Article 42 read with Article 22.
[42] Article 34 (1)(a).

(e) the total amount of remuneration for the financial year, split into fixed and variable remuneration paid by the AIFM to its staff, 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.

European Commission's Request for Advice to ESMA (CESR)

1. ESMA is requested to advise the Commission on the content and format of the annual report. In its advice, ESMA should consider whether all or any of the information referred to in Article 23 should be included in the annual report and the need for appropriate explanatory notes.

2. ESMA is requested to advise the Commission on the content and the format of a balance sheet or a statement of assets and liabilities. In its advice, ESMA should specify in particular:

   - the appropriate presentation, elements and level of detail of the AIF's assets;
   - the appropriate presentation, elements and level of detail of the AIF's liabilities;
   - the appropriate presentation, the elements and level of detail of net assets (shareholders' or unitholders' equity); and
   - the statement of cash inflows to and outflows from the AIF.

3. ESMA is requested to advise the Commission on the content and format of an income and expenditure account for the financial year. In its advice, ESMA should specify in particular the elements and the level of detail of AIF's income and expenditure accounts.

4 ESMA is requested to advise the Commission on the content and format of the report on the activities of the financial year. In its advice, ESMA should consider specifying inter alia:

   - statement explaining how the AIF has invested its assets during the relevant period in accordance with its published investment policy;
   - overview of the AIF's portfolio and, where appropriate, the AIF's major investments; financial results; and
   - directors' and corporate governance report depending on the legal structure of the AIF.

5. ESMA is requested to advise the Commission on how material changes in the information listed in Article 23 during the financial year covered by the report should be best presented in the annual report.

6. ESMA is requested to advise the Commission on the content and the format of the remuneration disclosure required under points (e) and (f) of Article 22(2) including the details on the form of remuneration.

Proposed Advice

Box 101

Annual Report Definitions

'Material change' (for the purposes of Article 22(2) (d) and with reference to Article 23, where appro-

priate) means changes in information if there is a substantial likelihood that a reasonable investor, becoming aware of such information, would reconsider its investment in the AIF, including for reasons that such information could impact an investor's ability to exercise its rights in relation to its investment, or otherwise prejudice the interests of one or more investors in the AIF.

Explanatory Text

11. The intention of the above approach is to provide a workable definition of 'material change' in relation to those items in Article 23 which would not usually, as a matter of course, be presented in the financial statements, and to apply the definition of 'material' as set out in the accounting framework adopted by the AIF, to assess changes in all remaining items in Article 23. Certain items in Article 23 are not required to be presented in the financial statements of the AIF under GAAP and, as a result, ESMA believes that these are best presented in a separate part of the annual report and made subject to a wider definition of materiality that is not focused on financial statements.

12. In addition, ESMA considers that the items which Article 23 requires AIFM to disclose to investors and make subject to disclosure in the annual report, should be based on a similar, consistent definition of 'material change'.

Proposed Advice

Box 102

General Principles for the Annual Report

1. An AIFM shall, for each EU AIF it manages and for each AIF it markets in the Union or a Member State territory only, make available an annual report in accordance with Article 22 (1) of Directive 2011/61/EU.
2. The accounting information contained in the annual report shall be prepared in accordance with the accounting standards applicable in the home Member State of the AIF, or, as the case may be, in accordance with the accounting standards of the third country where the AIF is established and with the accounting rules laid down in the AIF rules or instruments of incorporation.
3. Where there is a conflict or dissimilarity between the accounting standards and the accounting rules that may apply to an AIF, the accounting rules shall be followed to the extent that this is permitted by national law. AIFM shall ensure that the accounting rules adopted provide investors with relevant and timely information with the most appropriate content and in the most appropriate format. In particular, where applicable accounting standards require consolidation of portfolio companies following an AIF acquiring control of a non-listed company or issuer under Article 26(1) of Directive 2011/61/EU, AIFs may be exempted from such requirements where specified in their accounting rules and where permitted under national law.
4. All information provided in the annual report, including that specified in Box 104 (Primary Financial Statements required under Article 22 (2) (a) and (b) of Directive 2011/61/EU), Box 105 (Content and Format of the Report on Activities for the Financial Year) and Box 106 (Content and Format of Remuneration Disclosure) shall be presented in a manner that provides materially relevant, reliable, comparable and clear information. AIFM shall ensure as far as reasonably possible that the annual report contains the information investors may need in relation to particular AIF structures.

Explanatory Text

13. The overarching principle is to ensure that the annual report provides investors with sufficient information in relation to the particular AIF structures in which they are invested, which is relevant, reliable, readily understandable and clearly presented. The qualitative characteristics of useful financial reporting as set out in the long established practitioner's Framework for the preparation and presentation of financial statements initially approved by the IASC in 1989 and adopted by the IASB in 2001,[43] identify the types of information that are likely to be most useful to users in making decisions about the reporting entity on the basis of information in its financial report. Financial information is considered useful when it is relevant and represents faithfully what it purports to represent. The usefulness of financial information is enhanced if it is comparable, from one period to the next, and understandable.

14. Paragraph 3 of the advice recognises that there may be situations where a conflict could arise between the requirements mandated by a particular set of accounting standards and those of investors which are set out in the accounting rules laid down in the AIF rules or instruments of incorporation of the AIF. An important example is the requirement to prepare consolidated accounts. Under the GAAP of some Member States, an AIF controlling underlying portfolio companies may be required to consolidate fully these companies' statements into its own financial statements. This can be an expensive and difficult requirement for an AIF. It could also mean that accounts are produced which are of no real value to investors. This has led to AIF rules or instruments of incorporation expressly excluding consolidation requirements. The intention of ESMA's advice in paragraph 3 is therefore to allow AIFs to prepare non-consolidated financial statements where this is permitted by national law.

Proposed Advice

Box 103

Reporting Material Changes for the Annual Report

1. In accordance with Article 22(2)(d) of Directive 2011/61/EU AIFM shall, for each EU AIF it manages and for each AIF it markets in the Union or a Member State territory only, make available an annual report for each financial year or period, which shall contain material changes in relation to the information listed in Article 23 of that Directive for the applicable financial year or period.
2. For the purposes of complying with Article 22(2)(d) AIFM shall assess changes in the information listed in Article 23 of the Directive in accordance with the meaning of material change in Box 101 (Annual Report Definitions) and the definition of material in the accounting framework adopted by the AIF, as applicable.
3. Where applicable, such information shall be disclosed in line with the requirements of the accounting standards and rules adopted by the AIF. AIFM shall make additional disclosures when compliance with the specific requirements of the accounting standards and rules may be insufficient to enable investors to understand the impact of the change, or, where the information has already been provided to existing and potential investors, the AIFM may refer them to the me-

[43] This framework is currently under revision as part of a joint project between the IASB and FASB. The Conceptual Framework project aims to update and refine the existing concepts to reflect the changes in markets, business practices and the economic environment that have occurred in the two or more decades since the concepts were first developed. Its overall objective is to create a sound foundation for future accounting standards that are principles-based, internally consistent and internationally converged

dium in which or where such detailed information has been made available.

4. Where the information required to be disclosed is not covered by the accounting standards applicable to an AIF, or its rules, a description of the material change/s should be provided together with any potential or anticipated impact on the AIF and/or investors of the AIF. Where such information has already been provided to existing and potential investors, a summary may be provided with a reference to the medium in which or where that information has been made available.

Explanatory Text

15. The overarching principle contained in Article 22(2)(d) is that AIFM must ensure that investors in the AIF are provided with sufficient information to enable them to understand and consider the impact of any material changes. Hence ESMA's advice mandates additional disclosure to investors where it is necessary to achieve this objective. Where the relevant information has already been provided to investors, a reference to the medium in which or where such information is available, with a summary of any such changes is regarded as sufficient to meet the requirements of Article 22(2)(d).

16. Material changes in the information listed in Article 23 (Disclosure to investors) should be disclosed in the annual report, within the financial statements, in line with the requirements of the accounting standards applicable to and rules adopted by the AIF. The intention behind this advice is to ensure consistency with the accounting framework adopted by the AIF. A number of the information requirements in Article 23 (1) are already covered by existing accounting standards. Examples include 23 (1) (a), (g), and elements of (h) and (i). It is likely that future accounting standards will also cover other requirements within Article 23 (1).

Proposed Advice

Box 104

Primary Financial Statements required under Article 22 (2) (a) and (b) of Directive 2011/61/EU

Content and Format of the Balance Sheet (or Statement of Assets and Liabilities)

1. In accordance with Article 22(2) (a) of Directive 2011/61/EU AIFM shall, for each EU AIF it manages and for each AIF it markets in the Union or a Member State territory only, include a balance sheet or a statement of assets and liabilities within the annual report of the AIF. The balance sheet or statement of assets and liabilities shall contain at least the following elements and underlying line items, where applicable and where appropriate in relation to the type of AIF:

   (a) 'Assets' comprising the resources controlled by the AIF as a result of past events and from which future economic benefits are expected to flow to the AIF. Assets shall, where appropriate, be sub-classified according to the following line items:

      (i) 'Investments' including but not limited to debt and equity securities, real estate and property and derivatives. This line item will depend on the nature and structure of the AIF and its investment profile;
      (ii) 'Cash and cash equivalents' including, but not limited to, cash-in-hand, demand deposits and, where applicable, other short term liquid investments;
      (iii) 'Receivables' including, but not limited to amounts receivable in relation to dividends

and interest, investments sold, amounts due from brokers and 'prepayments' including amounts paid in advance in relation to expenses of the AIF.

(b) 'Liabilities' comprising present obligations of the AIF arising from past events, the settlement of which is expected to result in an outflow from the AIF of resources embodying economic benefits. Liabilities shall be sub-classified according to the following line items where this is appropriate according to AIF type:

(i) 'Payables' including but not limited to amounts payable in relation to the purchase of investments or redemption of units or shares in the AIF and amounts due to brokers and 'accrued expenses' including but not limited to liabilities for management fees, advisory fees, performance fees, interest and other expenses incurred in the normal course of operations of the AIF;
(ii) 'Borrowings' including amounts payable to banks and other counterparties;
(iii) 'Other liabilities' including but not limited to amounts due to counterparties for collateral on return of securities loaned, deferred income and dividends and distributions payable

(c) 'Net Assets' representing the residual interest in the assets of the AIF after deducting all its liabilities.

2. The layout, nomenclature and terminology of line items should be consistent with the accounting standards applicable to or the rules adopted by the AIF, and comply with applicable legislation where the AIF is established. Such line items may be amended or extended by the AIFM in line with its obligations to ensure compliance with the above.

3. AIFM shall present additional line items, headings and subtotals in the balance sheet or statement of assets and liabilities when such presentation is relevant to an understanding of an AIF's financial position. Where relevant additional information shall be presented in the notes to the financial statements. The purpose of the notes is to provide narrative descriptions or disaggregation of items presented in the primary statements and information about items that do not qualify for recognition in these statements.

4. AIFM shall separately present each material class of similar items. Individual items, if material, should be disclosed. Materiality should be assessed under the requirements of the accounting framework adopted.

5. AIFM shall retain the presentation and classification of items in the balance sheet or statement of assets and liabilities, from one reporting or accounting period to the next unless it is apparent that another presentation or classification would be more appropriate to the AIFM's reporting obligation, or because an accounting standard has required a change in presentation.

Content and Format of the Income and Expenditure Account

6. In accordance with Article 22(2) (b) of Directive 2011/61/EU AIFM shall, for each of the EU AIF it manages and for each AIF it markets in the Union or in a Member State territory only, make available an annual report for each financial year which shall contain an income and expenditure account for the financial year or, where applicable, the relevant financial period.

7. The income and expenditure account shall at least contain the following elements and underlying line items unless this information is not relevant to the type of AIF concerned:

(a) 'Income' representing any increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in net assets other than those relating to contributions from investors. Income shall, where applicable and appropriate, be sub-classified according to the following line items:

(i) Investment income which can be further sub classified as follows:
i. 'dividend income' relating to dividends on equity investments to which the

AIF is entitled;

ii. 'interest income' relating to interest on debt investments and cash to which the AIF is entitled;

iii. 'rental income' relating to rental income from property investments to which the AIF is entitled;

(ii) 'Realised gains on investments' representing gains on the disposal of investments;

(iii) 'Unrealised gains on investments' representing gains on the revaluation of investments; and

(iv)'Other income' including fee income from securities loaned and from miscellaneous sources.

(b) 'Expenses' representing decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in net assets, other than those relating to distributions to investors. Expenses shall, where applicable and appropriate, be sub classified according to the following line items:

(ii) 'Investment advisory/management fees' representing contractual fees due to the advisor or AIFM as applicable; and

(iii) 'Other expenses' including, but not limited to, administration fees, professional fees, custodian fees and interest. Individual items, if material in nature, should be disclosed separately.

(b) 'Net income/expenditure' representing the excess of income over expenditure or expenditure over income as applicable.

8. The layout, nomenclature and terminology of line items should be consistent with applicable accounting standards or rules adopted by the AIF, and comply with existing legislation of the jurisdiction where the AIF is established. As a result the above line items may be amended or extended by the AIFM in line with its obligations to ensure compliance.

9. AIFM shall present additional line items, headings and subtotals in the income and expenditure account when such presentation is materially relevant to an understanding of an AIF's financial performance. Such additional information shall be presented in the notes to the financial statements. The purpose of these notes is to provide narrative descriptions or disaggregated items in the primary statements, as well as information about items that do not qualify for recognition in these statements.

10. AIFM shall separately present each material class of similar items. Individual items, if material, shall be disclosed. Materiality shall be assessed under the requirements of the accounting framework adopted.

11. AIFM shall recognise all items of income and expense in a given period in the income and expenditure account unless an accounting standard adopted by the AIF requires or permits otherwise.

12. AIFM shall retain the presentation and classification of items in the income and expenditure account from one period to the next unless it is apparent that another presentation or classification would be or has become more appropriate, or an accounting standard requires a change in the presentation of these items.

Explanatory Text

17. Financial statements of an AIF portray the financial effects of transactions and other economic events by grouping these into broad classes according to their economic characteristics. These broad classes

are termed the elements of financial statements. ESMA's advice is accordingly centred on the key elements from which financial statements are constructed.

18. ESMA's intention is to provide a non-exhaustive list of underlying line items together with the flexibility to present additional line items, headings and sub totals where the presentation of these items is relevant to an understanding of an AIF's overall financial position or performance. In addition, our advice considers that the presentation of line items should be mandated where such line items (or class of similar items) are regarded as materially relevant under the applicable accounting standards adopted by the AIF. The flexibility also allows the aggregation of items of a dissimilar nature or function where such items are individually not materially relevant.

19. In practice, immaterial items of a dissimilar nature may be aggregated under an 'other' category. For example, 'other assets', 'other liabilities', 'other income' or 'other expenses'. Where line items do not apply to a particular AIF they do not need to be presented. For example it is likely that rental income will only be applicable to AIF which invest in physical assets; unrealised gains will only be applicable to those AIF which report their investments in the financial statements at 'fair value'. However, it is important to note that regardless of the accounting treatment followed, Article 19 (3) of the Directive requires that all assets are valued at least once per year. ESMA has further specified its advice in relation to valuation requirements in Part IV.VII of this paper. IOSCO's paper on 'Objectives and Principles of Securities Regulation' reinforces that regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme.

20. Where relevant, additional information must be presented in the notes to the financial statements. The purpose of these notes is to provide narrative descriptions or disaggregation of items presented in the primary statements and to provide information about items that do not qualify for recognition in these statements. For example, if there have been transactions between related parties, an AIF should disclose the nature of the related parties' relationship, with information about the transaction and outstanding balances, in the notes to the financial statements.

21. The definitions presented in ESMA's advice are consistent with those set out in the IASB's 'Framework for the Preparation and Presentation of Financial Statements' but nonetheless allow flexibility to incorporate future changes within the IASB Framework, or where these apply by virtue of the accounting standards adopted by the AIF. The purpose of this framework includes promoting harmonisation of regulations, accounting standards and procedures relating to the presentation of financial statements, and assisting national standard setting bodies in developing national standards.

22. ESMA's advice also applies the overarching requirement that financial statements should be presented in a manner most relevant to investors gaining a proper understanding of the financial position and performance of the AIF. Yet the advice nonetheless provides for consistency with national accounting standards or rules, recognising the concept of materiality as defined in the accounting framework already adopted by the AIF. As part of its advice in relation to the content and format of a balance sheet or a statement of assets and liabilities, ESMA has been requested to specify in particular the statement of cash inflows to and outflows from the AIF. However the statement of cash flows, or, cash flow statement as it is sometimes referred, is a separate primary statement and does not form part of the balance sheet or statement of assets and liabilities. Presentation of this statement will depend on the GAAP adopted by the AIF and, on the size and nature of the AIF. For example, presentation of a cash

flow statement is always required under IFRS but sometimes required by US GAAP and national GAAPs.

Proposed Advice

Box 105

Content and Format of the Report on Activities for the Financial Year

1. In accordance with Article 22(2) (c) of Directive 2011/61/EU AIFM shall, for each of the EU AIF it manages and for each AIF it markets in the Union or in a member state territory only, make available a report on the activities of the financial year, or, where applicable, the activities of the relevant financial period within the annual report, which shall contain at least the following elements:
   (a) an overview of investment activities during the year or period, and an overview of the AIF's portfolio at year-end or period end;
   (b) an overview of AIF performance over the year or period; and
   (c) material changes in the information listed in Article 23 of the Directive not already presented in the financial statements.
2. The report shall include a fair and balanced review of the activities and performance of the AIF, containing also a description of the principal risks and investment or economic uncertainties that the AIF may face.
3. To the extent necessary for an understanding of the AIF's investment activities or its performance, the analysis shall include both financial and, where applicable according to the AIF type, non-financial key performance indicators relevant to that AIF.
4. The information provided in the report should be consistent with national rules where the AIF is established.

Explanatory Text

23. ESMA's overarching approach in relation to the presentation of a report on the activities of the AIF is to ensure that investors are provided with information which is sufficient in relation to their particular AIF structures, which is relevant, reliable, readily understandable and clear.

24. ESMA advises that the report should include a fair and balanced review of the activities and performance of the AIF with a description of the principal risks and investment or economic uncertainties that it faces. This is consistent with the requirements set out in Directive 83/349/EEC (Seventh Council Directive on consolidated accounts). However, the disclosure should not seek to make public any proprietary information of the AIF. ESMA considers that the information provided should be at a reasonably high level and should therefore not capture the performance or the statistics of an individual portfolio company or investment that could lead to the disclosure of proprietary information of the AIF.

25. ESMA's view is that this section should form part of the Directors or Investment Managers Report insofar as this is usually presented alongside the financial statements of the AIF.

Proposed Advice

Box 106

Content and Format of Remuneration Disclosure

1. In accordance with Article 22(2) (e) of Directive 2011/61/EU AIFM shall, for each EU AIF it manages and for each AIF it markets in the Union or in a Member State territory only, disclose within the annual report of the AIF concerned the total amount of remuneration for the financial year, split into fixed and variable components.
2. AIFM shall specify whether the total remuneration disclosed in the AIF's Annual Report relates to :
   (a) the total remuneration of the entire staff of the AIFM; or
   (b) the total remuneration of those staff of the AIFM who in part or in full are involved in the activities of the AIF; or
   (c) the proportion of the total remuneration of the staff of the AIFM attributable to the AIF.
3. Where this information is disclosed at the level of the AIFM, an allocation or breakdown should be provided in relation to each AIF, insofar as this information exists or is readily available. As part of this disclosure, the AIFM should include a description of how the allocation or breakdown has been provided.
4. In relation to the requirements of Article 22 (2) (f) of Directive 2011/61/EU aggregated amounts broken down by senior management and those members of staff whose professional activities have a material impact on the risk profile of the AIF shall be disclosed unless any such disclosure would breach the requirements of Directive 95/46/EC or other applicable legislation.
5. AIFMs shall provide general information relating to the financial and non-financial criteria of the remuneration policies and practices for relevant categories of staff to enable investors to assess the incentives created.
6. In accordance with the principles set out in Annex II (Remuneration Policy) of Directive 2011/61/EU AIFMs shall disclose at least the information necessary to provide an understanding of the risk profile of the AIF and the measures it adopts to avoid or manage conflicts of interest.

Explanatory Text

26. The Directive stipulates in Article 22(2)(e) that the total amount of remuneration for the financial year, split into fixed and variable components paid by the AIFM, should be disclosed as with the number of beneficiaries. This article does not specify whether total remuneration should be set at the level of the AIF or the level of the AIFM. However, in view of the fact that Article 22(4), consistent with Article 23 (6) in relation to disclosure to investors, states that the measures adopted by way of delegated acts shall be adapted to the type of AIF to which they apply, ESMA's view is that AIFM should have the ability to choose to present total remuneration at either the level of the AIFM, or the AIF, as the case may be, provided adequate disclosure is made.

27. Where information is presented at the level of the AIFM further perspective should be provided by disclosing an allocation or breakdown of the total remuneration as it relates to the relevant AIF. This could be achieved through disclosure of the following:

(i) total AIFM remuneration data split in to fixed and variable components;

(ii) a statement that this data relates to the entire AIFM, and not to the AIF;

(iii) the number of AIF and UCITS (if any) funds managed by the AIF; and

(iv) the total AUM of such AIFs and UCITS with an overview of the remuneration policy and a reference to where the full remuneration policy of the AIFM is available at the request of investors.

28. Further context may be provided by the AIFM by disclosure of the total variable remuneration funded by the AIF through payment by it of performance fees or carried interest, as the case may be.

29. In addition, the Directive requires disclosure of 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. ESMA suggests that account should be taken of the work undertaken as part of the EBA's guidelines[44] in relation to the identification and categories of 'staff whose actions have a material impact on the risk profile' to ensure consistency in approach, and proportionality. However, ESMA believes that additional tailoring would be required to reflect the specifics of the asset management industry in line with the flexibility needed for the diverse AIF population, an approach already applied in relation to Article 22(4), 23 (6) and elsewhere in the Directive.

30. Paragraph 4 of ESMA's advice seeks to ensure proportionate application of the Directive to avoid situations where smaller AIFM would be required to disclose information which would in effect identify the remuneration of an individual member of staff of that AIFM. ESMA acknowledges that there may be some situations where conflict may arise between the obligation on an AIFM to disclose information which may be proprietary or confidential to that AIFM.

31. Paragraphs 5 and 6 of ESMA's advice seek to ensure that in all cases sufficient information is disclosed by AIFM to allow investors to assess the incentives created and to understand the risk profile of the AIF concerned.

Q63: Do you agree with the approach in relation to the format and content of the financial statements and the annual report? Will this cause issues for particular GAAPs?

Q64: In general, do you agree with the approach presented by ESMA in relation to remuneration? Will this cause issues for any particular types of AIF and how much cost is it likely to add to the annual report process?

[44] http://www.eba.europa.eu/cebs/media/Publications/Standards%20and%20Guidelines/2010/Remuneration/Guidelines.pdf

VIII.II. Possible Implementing Measures on Disclosure to Investors

1. Investors should have access to a minimum level of information disclosed by AIFMs for each AIF marketed within the Union or a member state only. The disclosure obligations on AIFMs apply to investors prior to any investment in the AIF(s) concerned and on an ongoing basis.

2. ESMA has been requested to provide advice in relation to the appropriate frequency, content and format of certain key disclosure obligations on AIFM, as outlined below. As noted previously, the Directive's provisions in relation to implementing measures for disclosure by AIFM to investors requires such measures to be adapted to types of AIF to which they shall apply[45]. AIFM should not engage in 'window dressing' activities immediately prior to making disclosure in accordance with this advice.

3. ESMA draws the Commission's attention to the required scope of the implementing measures for Article 23. The proposed advice in Boxes 107 to 108 should cover EU AIFMs for each AIF marketed in the Union with a passport, as well as for all EU and non-EU AIFMs marketing non-EU AIFs in the territory of a Member State only, where that Member State permits private placement to professional investors under national law[46].

4. Respondents to the call for evidence felt that, where it has been made clear from the outset that the AIF invests in illiquid assets and investors have been made aware of the potential impact, this should be reflected in the frequency of the disclosure. On leverage, it was pointed out that ESMA should provide some standard methodologies such as gross leverage, net leverage and ex-post volatility to allow for easy comparison of different AIFs by investors.

5. Some respondents were of the view that the risk profile of the AIF should be provided only according to the strategies followed by the manager. There were also requests for the advice to clarify that in the case of funds without redemption rights and which invest in illiquid assets, an initial disclosure of that business model should suffice and that the periodic disclosure requirements in Article 23(4) would not apply.

Scope of the Commission's implementing powers

The Commission shall adopt, by means of delegated acts, in accordance with Article 56, and subject to the conditions laid down in Articles 57 and 58, measures specifying the disclosure obligations of AIFM referred to in paragraphs 4 and 5, including the frequency of the disclosure referred to in paragraph 5. Those measures shall be adapted to the type of AIFM to which they apply.

Extract from Level 1 text:

Article 23(4)

AIFMs shall, for each of the EU AIFs that they manage and for each of the AIFs that they market in the Union, periodically disclose to investors:

[45] Article 23 (6)
[46] Article 23 read with Article 42

(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.

Article 23(5)

AIFMs managing EU AIFs employing leverage or marketing in the Union AIFs employing leverage shall, for each such AIF disclose, on a regular basis:

(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 reuse of collateral or any guarantee granted under the leveraging arrangement;

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

Commission Request for Advice to ESMA (CESR)

1. With respect to the disclosure obligations in Article 23(4), ESMA has been requested to advise the Commission on:

   - the appropriate frequency of such disclosures;

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

   - the information and the essential elements to be disclosed by the AIFM to enable appropriate description of the risk management systems employed by the AIFM to manage these risks including results of recent stress tests.

ESMA is requested to adapt its advice to the types of AIFM.

2. With respect to the disclosure obligations in Article 23(5), ESMA has been requested to advise the Commission on:
   - the appropriate frequency of such disclosures;
   - the essential information, and the format thereof, to ensure an appropriate description of changes to the maximum level of leverage which the AIFM may employ on behalf of the AIF as well as any right of re-use of collateral or any guarantee granted under the leveraging arrangement; and the leverage measures or ratios, and the format thereof, to be used by the AIFM when disclosing the total amount of leverage employed by the AIF during the reporting period and at the end of the reporting period including those specified according to Article 4.

Proposed Advice

Box 107

Periodic Disclosure to Investors

Percentage of Assets Subject to Special Arrangements

1. For the purposes of Article 23(4) (a) of Directive 2011/61/EU the percentage of assets subject to special arrangements as defined in Box 31 (Liquidity Management Definitions) shall be calculated as the net value of those assets subject to special arrangements, divided by the net asset value of the AIF concerned.

2. This information shall be disclosed as part of the AIF's periodic reporting to investors, as required by the AIF rules or instruments of incorporation, prospectus and offering documents and, at a minimum, in the annual report of the AIF.

3. The required disclosure shall contain an overview of any special arrangements including the valuation methodology applied to the special arrangements and how management and performance fees apply to these assets.

New arrangements for managing the liquidity of the AIF

4. AIFMs shall disclose whenever they make any material changes, in accordance with the measures in Box 101 (Annual Report Definitions) to the liquidity management policies and procedures adopted for monitoring the liquidity risk of the AIF and ensuring that the liquidity profile of the investments of each AIF aligns with the AIFM's obligations in relation to liquidity management. AIFMs shall immediately notify investors where they activate gates, side pockets or similar special arrangements or where they decide to suspend redemptions.

5. The required disclosure shall contain an overview of the changes to the arrangements relating to liquidity, whether special arrangements or other arrangements, including where relevant the terms under which redemption is permitted and the circumstances defining when management discretion shall apply.

Risk profile of the AIF

6. AIFMs shall disclose the current risk profile of each AIF as part of their obligations relating to periodic disclosure to investors as required by the AIF rules or instruments of incorporation, prospectus and offering documents and, at a minimum, in the annual report of the AIF.

OPTION 1

7. AIFM shall ensure that periodic disclosures shall contain an assessment of the exposure of the AIF's portfolio to the most relevant risks to which the AIF is, or could be, exposed, including where risk limits set by the AIFM have been, or are likely to be, exceeded. Where these risk limits have been exceeded the disclosure should additionally include a description of the circumstances and, where applicable, the remedial measures taken.

[or]

OPTION 2

3. Periodic disclosure by AIFM shall contain all of the following:

   (a) identification of the most relevant risks to which the AIF is or could be exposed;
   (b) measures used by the AIFM to assess any sensitivity in the AIF portfolio to the most relevant risks to which the AIF is, or could be, exposed; and
   (c) the results of any relevant stress tests, or an indication as to whether, in the opinion of the AIFM, the exposure is likely to increase, is stable or is decreasing and within, near to, or exceeding risk limits set by the AIFM. Where risk limits have been exceeded the disclosure shall additionally include a description of the circumstances and, where applicable, the remedial measures taken.

Risk management systems employed by the AIFM

4. The main features of the risk management systems employed by the AIFM to manage the most relevant risks to which each AIF it manages is or may be potentially exposed, shall be made

available to investors prior to investment.

5. AIFMs shall provide an overview of the procedures employed to assess the most relevant risks to which each AIF it manages is exposed and the techniques, tools and arrangements it employs to manage these risks.
6. Thereafter disclosure obligations shall be triggered where there are material changes in accordance with the definition in Box 101 (Annual Report Definitions). Such disclosure shall include information relating to the change and its anticipated impact on the AIF and its investors.

Explanatory text

Percentage of Assets Subject to Special Arrangements

6. ESMA is of the opinion that a special arrangement is one type of tool or arrangement for managing liquidity. ESMA has proposed that special arrangements be defined with reference to relevant provision in the AIFM Directive. ESMA intends this definition to include 'side pockets' and other mechanisms where certain assets of the AIF are subject to similar arrangements between the AIF and its investors. ESMA believes that the suspension of an AIF should not be considered to be a special arrangement as this does not constitute a separate or bespoke arrangement but rather an 'arrangement' which applies to all of the AIF's assets and all of the AIF's investors. Other 'arrangements' such as gates should be considered as special arrangements where they achieve outcomes similar to those achieved by side pockets.

7. Considering the need to minimise – in relation to any given transparency requirement – the administrative burden for AIFs and AIFMs, ESMA proposes that the percentage of assets subject to special arrangements should be calculated as the value of those assets subject to special arrangements divided by the net asset value of the AIF.

8. In circumstances where the AIF is unitised transfers of any assets to side pockets should be calculated, at the time of transfer, based on the number of units allocated on transfer of assets multiplied by the price per unit. The valuation basis should be clearly disclosed in all circumstances and include the date at which the valuation was performed.

9. In all cases, disclosure should include an overview of the special arrangements in place, setting out whether they relate to side pockets, gates or other such similar arrangements, the valuation methodology applied to the assets subject to such arrangements, and how management and performance fees apply to the assets made subject to any such special arrangements.

10. The frequency of disclosure should be consistent with the AIF's periodic reporting to investors, for example, where investors provide quarterly reports to investors these disclosures should form part of this periodic reporting, or at a minimum, this should be done on an annual basis.

New arrangements for managing the liquidity of the AIF

11. ESMA's advice is that the trigger for this disclosure is circumstances giving rise to material change to the liquidity management policies and procedures. In such cases AIFMs should be required to notify investors as soon as a gate is activated, or side pockets or other special arrangements for managing liquidity are used, or when AIFM intend to suspend redemptions in exceptional circumstances.

12. Such disclosure shall contain an overview of any material changes made to the arrangements including, where relevant, the terms under which redemption is permitted, and circumstances defining when management discretion shall apply. Where appropriate the following should also be disclosed: any voting or other restrictions exercisable, the length of any lock–ups, or any rules relating to 'first in line' or 'pro-rating' on gates and suspensions.

13. In order to manage liquidity, it is sometimes the case that AIFM may enter into borrowing arrangements on behalf of AIF they manage. These can be short term, or, more permanent arrangements in which case it is more likely that such an arrangement is a special arrangement for the purpose of managing illiquid assets.

Risk profile and risk management systems

14. In line with the principle of differentiation, and recognising the diversity of AIF models, the disclosure required of an AIFM should vary according to AIF type and will depend on other factors including investment strategy and asset class. Accordingly, any implementing measures should be able to accommodate a broad range of approaches. These measures should also be capable of calibration in an appropriately differentiated and proportionate manner.

15. ESMA has set out two possible options in relation to the disclosure of the risk profile of the AIF. The first such option provides more discretion for the AIFM to determine appropriate disclosures in relation to the AIF's particular structure and investment strategy. The second option is more prescriptive.

16. The frequency of disclosures required of AIFM under this heading should be consistent with the AIF's periodic reporting to investors. For example, where investors provide quarterly reports to investors these disclosures should form part of this reporting, or at a minimum, be made on an annual basis.

Proposed Advice

Box 108

Regular Disclosure to Investors

1. Whenever material changes occur in relation to the elements in Article 23(5) (a) of Directive 2011/61/EU, a disclosure requirement shall be triggered for the AIFM concerned. Such disclosure should contain the following information, as appropriate to the type of AIF:

   (a) the original and revised maximum leverage level in accordance with the methods of calculation of exposure of AIF in Box 95 (Gross Method of Calculating the Exp0sure of the AIF), and, either Box 96 (Commitment Method of Calculating the Exposure of an AIF) or, where applicable, Box 97 (Advanced Method of Calculating the Exposure of an AIF). The level of leverage shall be calculated in each case as the relevant exposure divided by the net asset value of the AIF;

   (b) the nature of the rights granted for the re-use of collateral;

   (c) the nature of guarantees granted; and

   (d) details of changes in any service providers disclosed in accordance with Article 23(1)(d)

which relates to paragraphs (a) to (c) above.

2. The information shall be presented in a clear and understandable way.
3. The information referred to in points (a) to (d) in Paragraph 1 shall be provided in a timely manner.
4. The total amount of leverage employed by an AIFM, on behalf of an AIF, in accordance with the methods of calculation of leverage set out in paragraph 1, shall be disclosed as part of an AIF's periodic reporting to investors as required under the AIF rules or instruments of incorporation, prospectus and offering documents and shall, at a minimum, be disclosed in the AIF's annual report.
5. The disclosure referred to in Paragraph 4 shall include a description of the leverage measures or ratios and their appropriateness when considered against the investment strategy of the AIF, as well as the maximum levels of leverage to which the AIF has been made subject by the AIFM.

Explanatory text

Disclosure of changes to the maximum level of leverage

17. ESMA's advice proposes that the trigger for disclosure under this heading should occur where a material change is made to the maximum leverage level of an AIF. To comply with its obligations under Article 23(5) of the Directive, AIFM must in all cases report the level of leverage with reference to the gross method of calculating exposure and, in addition, must report the levels of leverage with reference to either the commitment or the Advanced Method of calculation, so that in all cases, at least two methods of calculation of leverage are disclosed to investors of the AIF.

18. The level of leverage should be calculated as the relevant exposure as determined in Boxes 95, 96 and 97 divided by the net asset value of the AIF.

Disclosure of the total leverage employed

19. ESMA's advice is that AIFM must in all cases report the total leverage employed with reference to the gross method of calculating exposure and, in addition, must report the levels of leverage with reference to either the commitment or the advanced method. This is consistent with the requirements in relation to changes in the maximum level of leverage.

20. ESMA considers that the frequency of disclosure should be consistent with the AIF's periodic reporting to investors. For example where investors provide quarterly reports to investors these disclosures should form part of this reporting, or at a minimum be reported on an annual basis.

21. The disclosure should include the following elements: leverage measures or ratios, their appropriateness or suitability given the investment strategy of the AIF, and the maximum leverage levels to which the AIF is subject, such that the information is placed in an appropriate and suitable context for investors.

Q65: Does ESMA's proposed approach in relation to the disclosure of 1) new arrangements for managing liquidity and 2) the risk profile impose additional liability obligations on the AIFM?

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

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

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

VIII.III. Possible Implementing Measures on Reporting to Competent Authorities

1. One of the main objectives of the AIFMD is to increase the transparency of AIFMs vis-à-vis competent authorities. To that end, the AIFMD requires AIFMs of all types to provide certain information on a regular basis to their home supervisors for each EU AIF they manage and for each of the AIF they market in the Union.

2. On the issue of a standard template for reporting to competent authorities, respondents to the call for evidence suggested that the specific items to be reported should not be assumed to have the same relevance for all AIFs. For instance, some stakeholders felt that counterparty risk for real estate funds was generally negligible and that the parties to rental agreements for the properties held in the portfolio should not be considered for the purposes of the counterparty risk calculation. One contributor saw merit in the development of a template to foster a standardised approach, while noting that the IOSCO document related to hedge funds only and therefore may not be appropriate to private equity or real estate.

3. Concerning the frequency of reporting, some respondents asked for annual reporting while acknowledging there might be a need to allow for ad hoc requests for further information.

4. In its advice, ESMA has determined the appropriate level of detail and harmonisation for these transparency requirements taking into account the importance of consistent reporting to achieve the objective of effective supervision and information exchange among the competent authorities and ESMA, the need to minimise the burden for competent authorities and the need to ensure that reporting requirements are proportionate taking into account the type, size and investment strategy of the AIFM.

5. In accordance with the Commission's request to ESMA, the template developed by IOSCO and published on 25 February 2010 concerning reporting by hedge funds, has been used as a starting point for the proposed draft advice. The concepts in the IOSCO template have been expanded to apply to AIFs of all types as required by the Directive.

6. The Commission also requested that ESMA consider the criteria to be used to determine under which conditions leverage is to be considered as being 'employed on a substantial basis'. As discussed elsewhere in this paper, leverage is a complex measure to calculate for the heterogeneous population of AIF covered by the AIFMD. As such, it is not deemed to be appropriate to seek to specify a quantitative threshold at which leverage would be considered to be employed on a substantial basis, as this may not always be the most insightful from the perspective of identifying systemic risk. Instead, it is proposed that a distinction is drawn based on whether the degree of leverage employed could contribute to the build-up of systemic risk in the financial system or the risk of disorderly markets.

Extract from Level 1 text – Article 24

1. *An AIFM shall regularly report to the competent authorities of its home Member State on the principal markets and instruments in which it trades on behalf of the AIFs it manages.*

It shall provide information on the main instruments in which it is trading, on markets of which it is a member or where it actively trades, and on the principal exposures and most important concentrations of each of the AIF it manages.

2. *An AIFM shall, for each of the EU AIF it manages and for each of the AIF it markets in the Union, the following to the competent authorities of its home Member State:*

   (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 the market risk, liquidity risk, counterparty risk and other risks including operational risk;
   (d) information on the main categories of assets in which the AIF invested;
   (e) the results of the stress tests performed in accordance with point (b) of Article 15(3) and the second subparagraph of Article 16(1).

3. *The AIFM shall, on request, provide the following documents to the competent authorities of its home Member State:*

   (a) an annual report of each EU AIF managed by the AIFM and of each AIF marketed by it in the Union, for each financial year, according to Article 22(1);
   (b) for the end of each quarter a detailed list of all AIF which the AIFM manages.

4. *An AIFM managing AIFs employing leverage on a substantial basis shall make available information about the overall level of leverage employed by each AIF it manages, a break-down between leverage arising from borrowing of cash or securities and leverage embedded in financial derivatives and the extent to which their assets have been reused under leveraging arrangements to the competent authorities of its home Member State.*

   That information shall include the identity of the five largest sources of borrowed cash or securities for each of the AIF managed by the AIFM, and the amounts of leverage received from each of those sources for each of those AIFs .

   For the non-EU AIFM, the reporting obligations set forth in this paragraph are limited to the EU AIF managed by them and the non-EU AIF marketed by them in the Union.

5. *Where necessary for the effective monitoring of systemic risk, the competent authorities of the home Member State may require information in addition to that described in this Article, on a periodic as well as on an ad-hoc basis. The competent authorities shall inform ESMA about the additional information requirements.*

   In exceptional circumstances and where required in order to ensure the stability and integrity of the financial system, or to promote long-term sustainable growth, ESMA may request the competent authorities of the home Member State to impose additional reporting requirements.

Scope of the Commission's implementing powers

The Commission shall adopt by means of delegated acts, in accordance with Article 56, and subject to the conditions laid down in Articles 57 and 58, measures specifying:

   (a) when leverage is to be considered to be employed on a substantial basis for the purposes of paragraph 4; and
   (b) the obligations to report and provide information provided for in this Article.

Those measures shall take into account the need to avoid excessive administrative burden for competent authorities.

Commission's Request for Advice to ESMA (CESR)

1. CESR is requested to advise the Commission for the purposes of paragraph 4 on the criteria to be used to determine under which conditions leverage is to be considered as being 'employed on a substantial basis'.

2. CESR is requested to advise the Commission on the content of the obligations to report and provide information referred to in paragraphs 1 through 5. In its advice, CESR should consider developing a comprehensive template to be used by AIFM for reporting to competent authorities the information required under Article 24. In developing such a template, CESR should take into account the reporting template issued by IOSCO on 25 February 2010 for reporting from hedge funds and templates used by national competent authorities. CESR should address, *inter alia*, the following elements:

   (a) Assets under management;

   (b) Performance and investor information;

   (c) Market and product exposure (long and short positions);

   (d) Regional focus;

   (e) Turnover and number of transactions, indication of markets in which trading can represent a significant proportion of overall volume, trading and clearing mechanisms;

   (f) Leverage and risk;

   (g) Asset and liability information; and

   (h) Counterparty risk

3. The template should be sufficiently flexible to accommodate the different types, sizes and investment strategies of AIFM, without compromising the objective of effective supervision.

4. CESR is requested to advise the Commission on:

   (a) the appropriate frequency of such reporting as a function of the potential risks posed by specific types of AIFM;

   (b) the modalities and forms for data transmission; and

   (c) whether the same conditions should apply to the additional information requirements referred to in Article 24(5).

Proposed Advice

Box 109

Format and Content of Reporting to Competent Authorities

1. In accordance with the requirements in Article 3(3)(d) or Article 24(1) of Directive 2011/61/EU an AIFM shall report on a quarterly basis to the competent authorities of its home Member State the following information:

(a) the main types of instrument in which it is trading, including a break-down of financial instruments and other assets, taking into account the AIF's investment strategy and its geographical and sector investment focus;
(b) the markets of which it is a member or where it actively trades;
(c) the diversification of the AIF's portfolio including, but not limited to, its principal exposures and most important concentrations.

2. The information required under paragraph 1 shall be provided no later than one month after the end of the relevant period.

3. In accordance with the requirements in Article 24(2) of Directive 2011/61/EU, an AIFM shall provide for each EU AIF it manages and for each of the AIF it markets in the Union, the following information to the competent authorities of its home Member State:

(a) the percentage of the AIF's assets which are subject to special arrangements arising from their illiquid nature in accordance with Article 23(4)(a) of Directive 2011/61/EU and in accordance with Box 31 (Liquidity Management Definitions);
(b) any new arrangements to manage the liquidity of the AIF;
(c) a description of the risk management systems employed by the AIFM to manage market risk, liquidity risk, counterparty risk and other risks including operational risk;
(d) the current risk profile of the AIF including:
(i) the market risk profile of the investments of the AIF including the expected return and volatility of the AIF in normal market conditions;
(ii) the liquidity profile of the investments of the AIF including the liquidity profile of the AIF's assets, the profile of redemption terms and the terms of financing provided by counterparties to the AIF;
(e) information on the main categories of assets in which the AIF invested including the corresponding short market value and long market value, the turnover and performance during the reporting period; and
(f) the results of periodic stress tests, under normal and exceptional circumstances, to the extent that AIFM are subject to the requirements of Article 15 (3)(b) and Article 16 (1) second subparagraph of Directive 2011/61/EU.

4. Where an AIFM is required to report under paragraph 3 it shall provide the information required on a quarterly basis. The information shall be provided no later than one month after the end of the relevant period.

5. As an exception to paragraph 4, a competent authority may deem it appropriate to require an AIFM to report all or part of the information on a more frequent basis.

6. AIFMs managing one or more AIFs which they have assessed to be employing leverage on a substantial basis in accordance with Box 110 (Use of Leverage on a Substantial Basis), shall provide the information required under Article 24(4) subparagraph of Directive 2011/61/EU at the same time as that required under paragraph 3.

7. AIFMs shall provide the information specified under paragraphs 1, 3 and 6 in accordance with the pro forma reporting template or, for information not specified in that template, in a manner determined by the competent authorities of the home Member State. However, where an AIFM is required to report information on a more frequent basis in accordance with paragraph 5, the competent authority of the home Member State may require an AIFM to provide all or part of the information specified in the pro-forma reporting template in a different format.

8. In accordance with Article 42 (1)(a) of Directive 2011/61/EU, for non-EU AIFMs any reference to the competent authorities of the home Member State shall mean the competent authority of the Member

State where the AIF is marketed.

Explanatory Text

7. The AIFMD requires AIFM of all types to provide certain information on a regular basis to the competent authority of the home Member State for each EU AIF they manage and for each of the AIF they market in the Union.

8. In accordance with the Commission's request to ESMA, the template developed by IOSCO and published on 25 February 2010 in respect of reporting from hedge funds has been used as a starting point for the proposed draft advice. The concepts in the IOSCO template have been expanded to apply to AIF of all types as required by the Directive. Annex V contains a draft pro-forma reporting template which ESMA believes should be used by AIFM to report under the default reporting requirements set out in ESMA's advice. Where the competent authority determines that an AIFM should report additional information, or, report part of the information on a more frequent basis, the advice recognises that it may be appropriate to depart from using the template and report in a different manner. ESMA notes that, in transposing Article 24 of the Directive, Member States will require non-EU AIFM to report appropriate and relevant information to competent authorities.

9. In all cases the information should be provided as at a specified date. ESMA considers it preferable to align the provision of information with the accounting reference date for the financial statements. As a result it is anticipated that information would be provided as at 31 December, 31 March, 30 June and 30 September and submitted no later than 30 days after the end of the relevant period.

10. Consistent with the Directive's requirements the advice further provides for competent authorities to require additional reporting where this is appropriate in light of systemic risk or the nature, scale and complexity of the AIF.

11. This approach incorporates the need for competent authorities to receive the information necessary for the purpose of identifying the extent to which the use of leverage contributes to the build-up of systemic risk in the financial system, or the risks of disorderly markets, or risks to the long term growth of the economy[47]. Notwithstanding anything contained herein, Article 46 of the Directive provides competent authorities with all supervisory and investigatory powers for the exercise of their functions including requiring authorised AIFMs to provide information.

12. Where possible, including under any future framework for reporting that may be developed by ESMA, competent authorities should require reporting by electronic means. In consideration of the need to avoid excessive administrative burden the specific modalities and forms of data transmission for any additional information requirements under the Directive have not been prescribed.

13. It is envisaged that a common framework for the inclusion of data of a numerical or currency type is adopted. ESMA proposes that such data is reported under a common specification (e.g., in €1000's) and any conversion of exchange rates to Euros is at a consistent exchange rate (e.g., the spot exchange rate at the last fixing time on the previous business day before the reported date of the data).

[47] Article 25(1).

14. ESMA will consider the merits for future guidelines to further define the specificities of reporting of the format and content of the information required under this box and Annex V including the reporting of stress testing.

Box 110

Use of Leverage on a 'Substantial Basis'

1. In order to comply with the requirements in Article 24(4) of Directive 2011/61/EU an AIFM employing leverage shall make an assessment for each EU AIF it manages and for each of the AIF it markets in the Union as to whether leverage is being employed on a substantial basis in accordance with the methods of calculation of exposure of AIF in Box 95 (Gross Method of Calculating the Exposure of the AIF) Box 96 (Commitment Method of Calculating the Exposure of an AIF) and, where applicable, Box 97 (Advanced Method of Calculating the Exposure of an AIF).

2. The assessment of whether leverage is employed on a substantial basis shall have regard to the following non exhaustive considerations:

   (a) the type of AIF under management including its nature, scale and complexity;
   (b) the investment strategy of the AIFM in relation to the AIF concerned;
   (c) the market conditions in which the AIF and the AIFM operate;
   (d) whether the exposures of an AIF arising through the use of leverage by an AIFM could constitute an important source of market risk, liquidity risk or counterparty risk to a credit institution or other systemically relevant institution;
   (e) whether the techniques employed by the AIFM through use of leverage could contribute to the aggravation or downward spiral in the prices of financial instruments or other assets in a manner which threatens the viability of these prices; and
   (f) whether the degree of leverage employed by an AIF could contribute to the build up of systemic risk in the financial system or risk of disorderly markets.

3. AIFM shall monitor, on an ongoing basis, their use of leverage and, where there is a material change shall carry out a new assessment.

4. The competent authorities of the home Member State of the AIFM shall consider the information collected under Article 24 in their determination of whether leverage is employed on a substantial basis and may review the assessment made by the AIFM having regard to the factors considered in accordance with paragraph 2. Where the competent authority considers that the AIFM is employing leverage on a substantial basis the additional reporting obligations in accordance with Article 24(4) Directive 2011/61/EU and Paragraph 7 of Box 109 (Format and Content of Reporting to Competent Authorities) shall apply to such AIFM.

5. AIFM shall notify the competent authorities of their home Member State of the outcome of their assessment in paragraph 1, and shall provide a copy of the assessment to the competent authorities upon request.

Explanatory Text

15. Leverage is a complex measure to calculate for the heterogeneous population of AIF covered by the AIFM Directive. As such, it is not deemed to be appropriate to seek to specify a quantitative threshold at which leverage would be considered to be employed on a substantial basis, as this may not always be the most insightful from the perspective of identifying systemic risk.

16. Instead, it is proposed that a distinction be drawn based on whether the degree of leverage employed could contribute to the build-up of systemic risk in the financial system or risk of disorderly markets. A non-exhaustive list of criteria has been provided to assist the AIFM in making its assessment. These criteria include: the nature, scale and complexity of the AIF under management, the investment strategy employed by the AIFM in relation to the AIF, current or anticipated market conditions, whether the exposures created could constitute an important source of market risk, liquidity risk or counterparty risk and whether the techniques employed by the AIFM through use of leverage could contribute to the aggravation or downward spiral in the prices of financial instruments or other assets in a manner that threatens the viability of these prices.

17. AIFM must inform their competent authority of the outcome of this assessment and must provide a copy of the assessment to the competent authority on request. It is envisaged, that after initial notification to the competent authority, AIFM will only need to provide additional notification where their status changes. However, AIFM should continue to monitor their use of leverage on an on-going basis and, reassess at each reporting point, required by Box 109, to enable completion of the reporting template. Where competent authorities deem it necessary to review the assessment they must consider the factors set out in paragraph 2 of this advice. Where the competent authority considers that the AIFM is employing leverage on a substantial basis then the additional reporting obligations under Article 24 (4) and (5) of the Directive shall be triggered.

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

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

Q71: Do you agree with the proposed reporting deadline i.e. information to be provided to the competent authorities one month after the end of the reporting period?

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

Annex I

Summary of questions

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

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

Q3: Do you consider that using the annual net asset value calculation is an appropriate measure for all types of AIF, for example private equity or real estate? If you disagree with this proposal please specify an alternative approach.

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

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

Q6: Do you agree that AIFMs should include the gross exposure in the calculation of the value of assets under management when the gross exposure is higher than the AIF's net asset value?

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

Q8: Do you consider that the proposed requirements for calculating the total value of assets under management set out in Boxes 1 and 2 are clear? Will this approach produce accurate results?

Q9: The risk to be covered according to paragraph 2 (b)(iv) of Box 6 (the improper valuation) would also include valuation performed by an appointed external valuer. Do you consider this as feasible and practicable?

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

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

Q12: Please provide empirical evidence for liability risk figures, consequent own funds calculation and the implication of the two suggested methods for your business. When suggesting different number, please provide evidence for this suggestion.

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

Q14: Paragraph 4 of Box 8 provides that the competent authority of the AIFM may authorise the AIFM to lower the percentage if the AIFM can demonstrate that the lower amount adequately covers the liabilities based on historical loss data of five years. Do you consider this five-year period as appropriate or should the period be extended?

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

Q16: Paragraphs 4 and 5 of Box 11 set out additional due diligence requirements with which AIFMs must comply when investing on behalf of AIFs in specific types of asset e.g. real estate or partnership interests. In this context, paragraph 4(a) requires AIFMs to set out a 'business plan'. Do you agree with the term 'business plan' or should another term be used?

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

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

Q19: ESMA would like to know which types of AIFM will have most difficultly in demonstrating that they have an independent risk management function? Specifically what additional proportionality criteria should be included when competent authorities are making their assessment of functional and hierarchal independence in accordance with the proposed advice and in consideration of the safeguards listed?

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

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

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

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

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

Q25: How difficult would it be to comply with a requirement by which the general operating account and the subscription / redemption account would have to be opened at the depositary? Would that be feasible?

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

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

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

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

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

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

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

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

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

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

Q36: Could you elaborate on the differences notably in terms of control by the depositary when the assets are registered directly with an issuer or a registrar (i) in the name of the AIF directly, (ii) in the name of the depositary on behalf of the AIF and (iii) in the name of the depositary on behalf of a group of unidentified clients?

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

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

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

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

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

Q42: As regards the requirement for the depositary to ensure the sale, issue, repurchase, redemption and cancellation of shares or units of the AIF is compliant with the applicable national law and the AIF rules and / or instruments of incorporation, what is the current practice with respect to the reconciliation of subscription orders with subscription proceeds?

Q43: Regarding the requirement set out in §2 of Box 83 corresponding to Article 21 (9) (a) and the assumption that the requirement may extend beyond the sales of units or shares by the AIF or the AIFM, how could industry practitioners meet that obligation?

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

Q45: Do you prefer option 1 or option 2 in Box 86? Please give reasons for your view.

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

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

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

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

Q50: Are there other events which should specifically be defined/presumed as 'external'?

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

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

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

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

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

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

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

Q58: Do you agree that when an AIFM calculates the exposure according to the gross method as described in Box 95, cash and cash-equivalent positions which provide a return at the risk-free rate and are held in the base currency of the AIF should be excluded?

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

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

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

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

Q63: Do you agree with the approach in relation to the format and content of the financial statements and the annual report? Will this cause issues for particular GAAPs?

Q64: In general, do you agree with the approach presented by ESMA in relation to remuneration? Will this cause issues for any particular types of AIF and how much cost is it likely to add to the annual report process?

Q65: Does ESMA's proposed approach in relation to the disclosure of 1) new arrangements for managing liquidity and 2) the risk profile impose additional liability obligations on the AIFM?

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

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

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

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

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

Q71: Do you agree with the proposed reporting deadline i.e. information to be provided to the competent authorities one month after the end of the reporting period?

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

Annex II

Commission's provisional request to CESR for technical advice

http://ec.europa.eu/internal_market/investment/docs/alternative_investments/level2/mandate_en.pdf

Annex III

Cost-benefit analysis

1. Exemptions (Article 3)

All references to 'the Discussion paper' in the section on exemptions refer to *Discussion paper on ESMA's policy orientations on possible implementing measures under Article 3 of the Alternative Investment Fund Managers Directive*, ESMA/2011/121.

1.1. Box 1: The identification of the portfolio of AIFs under management by a particular AIFM and calculation of the value of assets under management, Article 3(2)

The AIFM shall identify the AIF it manages and calculate the value of assets under management including the effect of leverage.

Risk addressed/Policy objective

The failure of an AIFM to properly identify its AIFs and the value of its assets under management could lead to a number of risks being ignored since it will not be authorised. For example, data will not be collected in a proper way which may lead to systemic risks being ignored, investor protection may suffer.

Scope issues

The different natures of possible AIFs are necessary to be taken into account when calculated.

Option	Benefits	Costs	Evidence
Proposed in Box 1, paragraph 1-2 and 6.	The proposed approach on the identification of AIFs under management is consistent with the capital requirements of the Directive. The proposed approach minimises the burden on the AIFM through requiring annual calculation and on-going monitoring of the value of assets under management. The Directive requires annual valuations for the purpose of the annual report, therefore this requirement does not place additional burden on the AIFM. Consistent approach to valuation in the Directive.	Some AIFs that today do not calculate NAV will be required to do so annually which implies an additional cost. AIFMs must allow for the competent authorities to access the data used to calculate assets under management. No transparency vis-à-vis investors and public required on the assets under management data.	Support from the industry as evidenced in the feedback on question 1-5 of the Discussion paper. Valuation rules are also subject to national regulation.

1.2. Box 1: Treatment of potential cases of cross-holding among the AIFs managed by an AIFM, Article 3(2)

Risk addressed/Policy objective

The failure of an AIFM to properly calculate its assets under management could lead to a number of risks being ignored since it will not be authorised. For example, data will not be collected in a proper way which may lead to systemic risks being ignored, investor protection may suffer.

Scope issues

When managing a fund of funds and the underlying funds there is only one set of underlying assets though each fund must be managed separately.

Option	Benefits	Costs	Evidence
Option 1: as set out in Box 1 paragraph 3	The benefits are that it will only consider the underlying assets under management while including any effects of leverage.	The costs are that it is more complicated to separate the underlying assets and any leveraged exposure. The option deviates from the standard set in Article 9(4) of the Directive and in Article 7(1) a (ii) of the UCITS Directive.	Does not increase systemic risk. Support from the industry as evidenced in the feedback on question 12-13 of the Discussion paper.
Option 2: as set out in point 1 on page 11 of the Discussion paper	The benefits are those of simplicity and clarity. The approach is in line with the approach set out in Article 9(4) of the Directive. The same approach is used in the UCITS Directive, see Article 7(1) a (ii).	The costs are that it will double count any assets managed through funds of funds or master/feeder structures which means that an AIFM may need to be authorised under the directive and therefore lay unnecessary burden on it.	Double counting of assets lead to small AIFM being required to seek authorisation and the illusion of systemic risk may be created.

1.3. Box 1: Determination of the value of the assets under management by an AIF for a given calendar year, Article 3(2)

Risk addressed/Policy objective

The failure of an AIFM to properly calculate its assets under management on a regular basis could lead to a number of risks being ignored since it will not be authorised. For example, data will not be collected in a proper way which may lead to systemic risks being ignored, investor protection may suffer

Scope issues

The different nature of possible AIFs makes it necessary to differentiate between how the different types of funds calculate the assets under management.

Option	Benefits	Costs	Evidence
1) As proposed in Box 1, paragraph 4	The proposal allows for the use of existing procedures since it uses the latest available net asset value including subscription and redemption activity and capital drawdowns. The requirement to monitor the level of assets under management and to recalculate where necessary reduces the risk of manipulation of assets under management in order to avoid being required to seek authorisation under the Directive.	Not requiring more frequent monitoring or calculation of NAV could lead to AIFMs not seeking authorisation in due time.	Support from the industry as evidenced in the feedback on question 9-11 of the Discussion paper.
2) Proposed in the Discussion paper, page 10, first bullet point	The advantage is that it will result in an exact level of the assets under management.	For AIFMs that do not calculate their assets under management on quarterly basis, this new requirement will lead to additional costs.	
3) Proposed in the Discussion paper, page 10, second bullet point	The advantage is that it is a less burdensome requirement for those AIFs that currently do not calculate NAV on a quarterly basis, i.e. it takes into account different types of AIF.	For AIFMs that do not monitor their assets under management on quarterly basis, this new requirement will lead to additional costs.	

1.4. Box 1: Treatment of AIFM whose total assets under management occasionally exceed and/or fall below the relevant threshold and notification to national competent authorities for AIFMs that no longer comply with the exemptions granted in Article 3(2)

Risk addressed/Policy objective

The failure of an AIFM to properly monitor its assets under management on a regular basis could lead to a number of risks being ignored since it will not be authorised. For example, data will not be collected in a proper way which may lead to systemic risks being ignored, investor protection may suffer.

Scope issues

It is necessary to establish the meaning of sufficient frequency of calculation/monitoring of the asset under management and how to deal with the oscillation above and below the thresholds. To ensure a harmonised implementation it is necessary to be as clear as possible on when a breach is of permanent nature.

Option	Benefits	Costs	Evidence

As set out in Box 1	AIFMs managing AIFs with temporarily fluctuating values will be able to take that into account. The proposal requires the AIFM to immediately notify the CA, rather than to seek for authorisation, after exceeding the threshold which avoids unnecessary costs for the AIFM. The requirement to monitor the thresholds reduces the risk of manipulation of assets under management in order to avoid being required to seek authorisation under the Directive. Monitoring provides flexibility for the AIFM which reduces costs in comparison to calculation requirements. The three month window provides clarity to what is considered 'of a temporary nature' The proposal also clarifies, through examples, which factors may or may not be taken into account for the assessment.	The continuing monitoring of assets under management could lead to increased costs for closed-ended funds and other funds that do not perform this task currently. Risk of the AIFM not seeking authorisation due to the misconception that the breach is temporary. Allowing for monitoring rather than calculation in between the yearly calculations could lead to an AIFM not being authorised.	Support from the industry as evidenced in the feedback on question 14-15 and 20-21 of the Discussion paper.

1.5. Box 2: Influence of leverage on the assets under management, Article 3(2)

Risk addressed/Policy objective

The failure to properly and consistently account for leverage when calculating the assets under management could lead to a number of risks being ignored. For example, data may not be collected and assessed in a proper way which may lead to systemic risks being ignored and a loss of investor protection, due to (for example) AIFM not being required to seek authorisation.

Scope issues

Different types of AIF use leverage in different ways and through different structures which needs to be accounted for.

Option	Benefits	Costs	Evidence
As set out in Box 2	Using the gross method as set out in Box 95 ensures consistent application of calculation methods which reduces costs for the AIFM.	Using measures of assets under management previously not used may require revised procedures within the AIFM.	Support from the industry as evidenced in the feedback on question 6-8 of the Discussion paper.

1.6. Box 3: Content of the obligation to register with national competent authorities and suitable mechanisms for gathering information, Article 3(3)

Registration requirements for entities falling below the thresholds.

Risk addressed/Policy objective

The proposal addresses macro- and micro-prudential risks as well as investor protection issues through ensuring that all AIFMs satisfy a specific set of requirements before operating across the EU and through ensuring that relevant macro-prudential data is shared at European level.

Scope issues

Many AIFMs do not produce an offering document as such for the AIFs they manage. For example a private equity fund often raises funds through negotiations with potential investors. Therefore it is necessary to specify the content of the information to be provided to the competent authorities.

Option	Benefits	Costs	Evidence
	The proposal allows for using information already produced by the AIFM in relation to its clients when registering with the competent authorities. A specification simplifies the production of the information for AIFs that currently do not have an adequate offering document available. The proposed approach does not create a requirement on AIFs to produce an offering document, since it focuses on the specific information instead of naming a document.	Depending on the type of AIF and jurisdiction the information required may not be available today and therefore the production of this information will lead to costs for the AIF.	Support from the industry as evidenced in the feedback on question 16-19 of the Discussion paper.

1.7. Box 4: The procedures for small managers to 'opt-in' to the AIFMD, Article 3(4)

Risk addressed/Policy objective

Inter alia, micro-prudential risks and investor protection issues to ensure symmetric information.

Scope issues

All AIFMs are subject to appropriate authorisation and registration requirements to ensure that they satisfy a specific set of requirements (minimum capital, fit and proper, transparency) before operating across the EU.

Option	Benefits	Costs	Evidence
Option as set out in Box 4	The proposal of small AIFMs to follow the same authorisation procedure as large AIFMs leads to a level playing-field between smaller and larger AIFMs. The requirement to submit only the documents previously not submitted and not all document set out in Article 7 will simplify the process for the AIFM since it will be less burdensome than resubmitting the documents. The requirement will also be beneficial for competent authorities since they already have access to the documents and therefore will not need to go through a new set of documents that have been previously submitted.	AIFMs that choose to opt-in are the smaller ones which means that costs relating to the authorisation process will be proportionately more burdensome than for the larger AIFM already within the scope.	This section was addressed through questions 22-25 of the consultation paper. Most respondents to the consultation were of the view that the procedure for AIFMs which choose to opt in under the Directive should be the same as for AIFMs that must comply with the AIFMD. Some stakeholders believed that the procedure should allow some flexibility and should be proportionate to the size of the AIFs. Furthermore it can be argued that it is not legally possible to apply a different authorisation procedure since Article 3(4) states that '[w]here AIFMs opt in, this Directive shall become applicable in its entirety'.
Option as set out in Discussion paper under 'Opt-in procedure'	The proposal to require small AIFMs to follow the same authorisation procedure as large AIFMs leads to a level playing field between smaller and larger AIFMs. The requirement to submit all documents set out in Article 7 will simplify the process for the AIFM since it will not need to go through previously submitted documents in order to ensure that they are up to date. The requirement will also be beneficial for competent authorities since they will not need to go through previously submitted documents from the AIFM.	Resubmitting documents implies a burden on the AIFM seeking authorisation. AIFMs that choose to opt-in are by definition smaller entities, which means that costs relating to the authorisation process will be proportionately more burdensome than for the larger AIFM already within the scope.	

2. Initial Capital and own funds

2.1. Box 6: Additional Own Funds and Professional Indemnity Insurance

Risks addressed / Policy objective

- Investor Protection
- Market Integrity
- Mitigation of asymmetric information

Scope Issues

Option	Benefits	Costs	Evidence
Option 1 (presented in the consultation paper) Principle Based definition followed by a non-exhaustive, indicative list of risks which must be covered	The list is non-exhaustive but provides the AIFM with indication on what is deemed as professional liability risk. The approach is consistent with listing risks in Annex X Directive 2006/48/EC but addresses risks specific to AIFM. The approach avoids that AIFM have too much discretion particularly when maintaining professional indemnity insurance and determining the policies. The approach avoids that material risks are excluded in the policies.	Depending on current insurance policies, extra costs for AIFM to adjust policies.	The great majority of the listed risks were provided by the industry according to the call for evidence. The listed risks have proved acceptable by part of AIFM and insurance industry according to several contacts.

Option	Benefits	Costs	Evidence

Option 2 Principle based definition with no indicative list	AIFM have a great amount of discretion and large flexibility when determining the professional liability risk (particularly within in the insurance policies) they are exposed to.	No protection of investor's interests, hence fund managers might follow their own interests. Investors' claims may not be covered by insurance policies. Operational risk management framework of the AIFM may disregard material risks.	

2.2. Box 7: Amounts of Own Funds or Coverage of Professional Indemnity Insurance

Risks addressed / Policy objective

- Asymmetric information

- Investor Protections
- Market Integrity

Scope Issues

Option	Benefits	Costs	Evidence
Option 1 Implementation of operational risk management policies and procedures including the set-up of an historical loss database and maintaining adequate financial resources to cover liability risk (presented in the task force paper).	Obligation for self-assessment of the AIFM in relation to identification and management of professional liability risk. Risk based self-assessment with regard to the adequate coverage of the liability risk. Mitigation of operational failures and liabilities is most relevant and of highest benefit for investors.	One-off costs for setting up policy and procedures and low costs for periodic review and maintenance to AIFM.	Operational risk management requirements for banks have proven necessary. Standards are already required in case of German open-ended fund management companies and have proven beneficial.
Option 2 No operational risk management policies and procedures. No self-assessment of liability risk by AIFM.	No implementation costs to AIFM, no regulatory costs.	Higher risk of operational failures of the AIFM resulting in liabilities to investors, which the AIFM can potentially not cover. High risk to market integrity.	

2.3. Box 8: Quantitative Own Funds requirement

Options	Benefits	Costs	Evidence
Option 1 Adapting the requirements in Art. 102-103 of Directive 2006/48/EC, basically 15% of net income	Consistency with existing regulation for banks as similar operational risks may be expected with regard to asset management. High liability risk coverage and hence high protection of investor claims.	High costs due to high capital requirements. High administrative burden for start-up AIFM.	

Option 2 (presented in the consultation paper) Base additional own funds requirement on 'assets under management' in line with Article 9(3) of the AIFMD. 0.0001 x AuM	The approach is based on the variable assets under management. This option is already implied in Article 9(3) of the AIFMD and in Article 7(1)(a)(i) of the UCITS Directive for the calculation of own funds referred to in those Articles. This option is therefore based on an existing method and does not introduce a new one.	Based on the assumption that liability risks rise with the value of the portfolios of AIFs managed by the AIFM but will not take into account small size AIFM having high income figures.	

Option 3 (presentend in the consultation paper) Adjusting requirements of Directive 2006/48/EC via taking the additional variable 'assets under management' into account and overall lowering the percentages. 0.000015 x AuM + 0.02 x relevant income	Approach is based on two components: Income and assets under management of the AIFM. Both variables are deemed as approximation for liability risk and additionally correct for adverse effects: The size component corrects for large AIFM having higher potential liability risk but low income figures. Conversely, the income component corrects for small size AIFM having higher income figures, which may be indication for higher taken risks.	One-off costs for setting up procedures for determine relevant income. Middle costs for maintaining reasonable own funds. Lower capital costs compared to option 1.	Evidence based on a small sample of German UCITs/AIF management companies' shows better approximation when taking both variables into account.

Option 4 Base additional own funds requirement on fixed overheads. Additional own funds is equal to 15% of the amount mandated by Article 9 paragraph 5.	The calculation of additional own funds builds on the existing requirements, rather than introducing an entirely new methodology.	Fixed overheads may not be an adequate approximation for the size of the AIFM and for professional liability risk. The fixed overhead requirement in Article 9 (5) AIFMD is rather considered to account for an orderly winding down of the AIFM. This would contradict the reasoning for additional own funds for liability risk as this should account for the going concern of the AIFM.	

2.4. Box 9 paragraph 1: Professional Indemnity Insurance

Options	Benefits	Costs	Evidence

Option 1 Specifying minimum requirements for insurance policies and eligible insurance undertakings (presented in the task force paper)	Minimum requirements for insurance companies avoids that AIFM have too much discretion when selecting insurance undertakings, as financial strength and claim paying ability may be not adequate in all insurance undertakings inducing additional risk to professional indemnity insurance coverage. Potentially not those high solvency standards for insurance undertakings in third countries. This can at least be partially compensated by requiring diligence of the AIFM when selecting undertakings taking financial strength into account. Minimum requirements for the insurance policies avoid that AIFM have too much discretion in determining the policies. The approach avoids that material risks are excluded in the policies, in order to e.g. lower premium of the insurance.	Higher premium as specific liability risks driving premia cannot simply be excluded.	No negative feedback received in the workshop.

Option 2 No requirements for policies and eligible insurance undertakings	High discretion and flexibility to AIFM for determining insurance policies.	No protection of investor's interests, hence fund managers might follow their own interests. Insurance undertakings may not be able to pay the claims. Investor's claims may be not covered by insurance policies. High risk to market integrity.	

2.5. Box 9 paragraph 2 and 3 Professional Indemnity Insurance

Options	Benefits	Costs	Evidence
Option 1 No minimum coverage specified for insurance policies	High discretion and flexibility to AIFM for determining coverage amounts.	No protection of investor's interests, hence fund managers might follow their own interests. Investor's claims may be not covered by insurance policies as coverage may be too low.	

Option 2 Specifying minimum coverage for insurance policies in line with Art. 7 (ii) of Directive 2006/49/EC	Consistency with existing regulation with regard to specific MiFID firms.	Inconsistent compared to the own funds requirements. No equalization of own funds requirements and insurance as disadvantage of insurance (e.g., higher legal and contract uncertainty, possible insolvency of the insurer) is not compensated by higher amounts.	
Option 3 Specifying higher minimum coverage for insurance policies compared to Art. 7 (ii) of Directive 2006/49/EC	Direct comparison with those certain MiFID firms is not adequate, particularly as those are not required to maintain additional own funds. Slightly higher minimum amounts better take into account the current uncertainty with regard to liability risks faced by AIFM, which may be potentially higher compared to the specific Mifid firms. Slightly higher minimum amounts better fits within the Directive, which equalizes the use of PII and own funds. A slightly higher minimum coverage compared to the amounts calculated as own funds requirement according to Box 3 accounts for higher uncertainty and risk in relation to the insurance coverage (e.g., higher legal and contract uncertainty, possible insolvency of the insurer) and aims to compensate this disadvantage.	Potentially higher minimum coverage amounts and hence potentially slightly higher premia.	Has been suggested by part of the AIFM industry after consulting insurance companies.

3. General principles

Risks addressed / Policy objective

- Investor Protection
- Market Integrity
- Mitigation of asymmetric information

Scope Issues

General principles apply to all AIFM.

3.1. Box 10 Duty to act in the best interests of the AIF or the investors of the AIF and the integrity of the market

Option	Benefits	Costs	Evidence
Option 1 (presented in the consultation paper) Adapting the UCITS L2 directive requirements	Consistency with existing regulation. Also, overall it might be beneficial to implement a level playing field with other investment funds for the general principles of AIFM investments.	Low incremental costs since qualified fund managers already comply with principles to act in the best interest of investors and UCITS managers have already to comply with respective rules.	Codes of conduct have proven valuable in other areas.

Option 2 No action	No additional regulatory costs.	No protection of investor's interests, hence fund managers might follow their own interests.	

3.2. Box 11 Due diligence requirements

Option	Benefits	Costs	Evidence
Option 1 Adapting the UCITS L2 directive requirements	Consistency with existing regulation. Level playing field with other investment funds.	Specific issues of specific types of AIFs (e.g. PE, RE, CE) are not addressed. Low incremental costs since qualified fund managers already comply with due diligence principles and UCITS managers have already to comply with respective rules.	

Option 2 Adapting the UCITS L2 directive requirements and adding specific provisions applicable to specific types of AIFs (presented in the consultation paper)	Due diligence requirements tailored to specific types of AIFs (e.g. PE, RE, Closed-end funds). This might be useful because of different types of products, different maturities etc. in specific types of AIFs.	Low incremental costs since qualified PE, RE, CE fund managers already comply with due diligence principles.	Feedback in industry workshop showed that specific due diligence principles are already regarded as market standard.

3.3. Box 12 reporting obligations in respect of execution of subscription and redemption of orders

Option	Benefits	Costs	Evidence
Option 1 Adapting the MiFID L2 directive requirements (presented in consultation paper)	Art. 40 L2 MiFID differentiates between professional and retail clients, therefore more adequate for AIFM Directive which addresses marketing only to professional investors.	Low incremental costs.	Evidence shows that MiFID rules for professional clients are sufficient for professional investors.

Option 2 Adapting the UCITS L2 directive requirements	Harmonised market standards for all investment funds.	High incremental costs for AIFM as well as higher supervisory costs because of more detailed obligations.	Perception that UCITS guidelines are not relevant for/ not favored by professional investors.

3.4. Box 13 Selection and appointment of counterparties and prime brokers

Option	Benefits	Costs	Evidence

Option 1 Selection criteria for counterparties and prime brokers (presented in the consultation paper)	Minimum standard for selection and appointment of counterparties and prime brokers. Minimization of default risk. Ensures investor protection, market integrity and financial stability.	Low incremental costs since qualified fund managers already follow similar market standards.	
Option 2 No criteria	Large flexibility regarding the choice of counterparties; lower costs to industry because unregulated companies can become supplier of respective services.	Not all fund managers comply with market standards resulting in higher risks for the investor and for financial stability. Inferior legal assertiveness of investors.	Lesson from financial crisis that without careful due diligence of counterparties high risk for the market as a whole.

3.5. Box 14 and 15 Execution of decisions to deal on behalf of the managed AIF (Box 14) and placing order s to deal on behalf of AIF with other entities for execution (Box 15)

Option	Benefits	Costs	Evidence
Option 1 Adapting the UCITS/MiFID L2 directive requirements and exempting specific types of assets (presented in the consultation paper)	Consistency with existing regulation. Level playing field with other investment funds and financial intermediaries, e.g. investment firms. Enhanced competition.	Depending on respective national law extra costs for fund managers of non UCITS.	MiFID rules for best execution are a market standard and have proven beneficial.
Option 2 Adapting the UCITS/MiFID L2 directive requirements and adding requirements for specific types of assets for which there are no different execution venues	Better investor protection.	Higher incremental costs and no added value compared to due diligence rules. Risk of unsuitable design of regulation.	

3.6. Box 16 and 17: Handling of orders and aggregation and allocation of trading orders

Option	Benefits	Costs	Evidence
Option 1 Adapting the UCITS L2 directive requirements for all types of assets (presented in the consultation paper)	Consistency with existing regulation for other investment funds and intermediaries.	Low incremental costs because of existing market standards.	UCITS rules for order handling are a market standard and have proven beneficial.
Option 2 Deviating rules for assets other than financial instruments	Better fit to specific assets.	Risk of unsuitable design of regulation due to diversity of assets other than financial instruments.	

3.7. Box 18: Inducements

Options	Benefits	Costs	Evidence
Option 1 Adapting the MiFID Level 2 directive requirements for all types of assets (presented in the consultation paper)	Consistency with existing regulation and equal treatment of all relevant market participants.	Incremental costs for adaptation of marketing structures.	
Option 2 No inducement rules	More flexibility for marketing models. Maintenance of existing infrastructures and marketing models in the market.	Less efficient markets due to non-transparent marketing structures resulting in higher costs for investors.	MiFID rules for inducements are a market standard and have proven beneficial.

4. Conflicts of interests

Risks addressed / Policy objective

- Asymmetric information
- Investor Protections
- Market Integrity

Scope Issues

4.1. Box 21 and 22: Conflicts of interest policy and independence in conflicts management.

Option	Benefits	Costs	Evidence
Option 1 Adapting the MiFID/UCITS L2 directive requirements (presented in the consultation paper)	Obligation for self-assessment of the AIFM in relation to identification and management of conflicts of interests should lead to enhancement of market integrity.	One-off costs for setting up policy and low costs for periodic review to AIFM.	Financial crisis showed conflicts of interests are source of mismanagement.
Option 2 No conflicts of interests policy	No implementation costs to AIFM and no regulatory costs.	Less efficient markets due to intransparent organisational structures of AIFM resulting in higher costs for investors. High risk to market integrity.	

4.2. Box 23: Recordkeeping of activities giving rise to detrimental conflicts of interest.

Options	Benefits	Costs	Evidence
Option 1 Adapting the MiFID/UCITS L2 directive requirements (presented in the consultation paper)	Enables AIFM to demonstrate compliance with conflicts of interest rules. Enables supervisory authority to monitor compliance of AIFM.	Low running costs for recordkeeping by AIFM.	

4.3. Box 24: Strategies for the exercise of voting rights

Options	Benefits	Costs	Evidence
Option 1 Adapting the UCITS Level 2 directive requirements (presented in the consultation paper)	Transparency for investors regarding voting strategies enhances investor confidence.	One-off costs for setting up policy and low costs for periodic review to AIFM.	

Option 2 No requirement for transparent voting strategies	More flexibility to AIFM regarding exercise of voting rights.	Risk of exercise of voting rights to the disadvantage of investors.	

5. Risk Management

5.1. Box 25 Risk management: specifying 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

Risks addressed / Policy objective

Scope Issues

Option	Benefits	Costs	Evidence
Specifying the outcome that the systems need to achieve	Provides for a harmonised approach to be taken across AIFM so that the systems that are put in place ensure the same regulatory outcome. Reduces the risk that an inappropriate system is placed on the AIFM just because it is included within the advice. This method would require the AIFM to assess the effectiveness of the system rather than follow a tick box approach.	There is a risk that there may be different interpretations by AIFM but the level of harmonisation achieved by this method is high with minimal costs.	Targeted industry engagement.
Specifying the individual systems that need to be employed	Provides an even higher level of harmonisation although it places a high level of risk on ESMA to ensure that the systems that are specified may not be appropriate for all types of AIFM	Implementing new systems will result in cost and if they are not appropriate to the AIFM may not bring about any benefit.	Targeted industry engagement.

5.2. Box 27: specifying the appropriate frequency of review of the risk management system

Option	Benefits	Costs	Evidence
Define a set period	Easy to follow and implement.	May either be too infrequent or too frequent which leads to increased costs for no benefit or does not cover the risks.	Targeted industry engagement.
Define trigger events that *may* indicate a review is required	Also easy to follow. It permits the frequency to vary between AIFM depending on the risks which is proportionate. The list is indicative.	Costs will relate to the risk management function monitoring when these trigger events have occurred or are about to occur.	Targeted industry engagement.
Define a trigger event and require a review for each time the event occurs	Also easy to follow.	The trigger events will have different impacts for each AIFM and requiring it to be undertaken for each event may not be proportional for the AIFM and lead to additional costs without reducing the risk that the policy and procedures have become inefficient.	Targeted industry engagement.

5.3. Box 30: specifying how the risk management function shall be functionally and hierarchically separated from the operating units, including the portfolio management function

Risks addressed / Policy objective:

Proper monitoring and limitation of micro-prudential risks.

Scope Issues:

Private equity managers, where investment decisions are taken on a collective basis.

Option	Benefits	Costs	Evidence
Option 1 No specification in addition to Level 1, up to AIFM	None	Cost of non-harmonisation; Different approaches among Member States.	
Option 2 Conditions as defined in the consultation paper	Alignment with UCITS, therefore same requirements for managers and consistency in procedures. Separation ensures internal control mechanism.	Potential additional costs for AIFM for risk manager and internal reporting lines.	Input from workshop: for PE and RE managers mostly portfolio management and risk management is not separated, but in the form of committees; hedge funds in general do have portfolio management and risk management already separated.

Option 3 Risk management structured in the form of independent committees	Use of current industry practise for PE and RE managers.	Restructuring of existing committees might be necessary to ensure independence of risk management from portfolio management. More complex for authorities and investors to recognize the separation.	Input from workshop: for PE and RE managers mostly portfolio management and risk management is not separated, but in the form of committees; hedge funds in general have portfolio management and risk management already separated.

5.4. Box 30: specifying specific safeguards against conflicts of interest.

Risks addressed / Policy objective:

Proper monitoring and limitation of micro-prudential risks.

Scope Issues:

Private equity managers, where decisions are subject to multiple reviews.

Option	Benefits	Costs	Evidence
Option 1 No specification in addition to Level 1, up to AIFM	None	Cost of non-harmonisation; Different approaches among Member States.	

Option 2 Conditions as defined in the consultation paper	Review of separation, governing body and investors need to be informed about potential conflicts of interest	Potential additional costs for AIFM arising from the involvement of governing body, targeting conflicts of interest, reporting to investors.	Easily applicable for hedge fund managers.

Option 3 Safeguards through committee structure as discussed in workshop	Existing organisational structures especially for PE and RE companies can remain unchanged.	Potential additional costs for authorities and investors to understand and approve the structure and members of committees and to get convinced about conflicts of interest getting sufficiently addressed.	Based on the discussions during the workshop and as already mentioned above the current practise for PE and RE managers is the assignment of committees.

6. Liquidity management

6.1. Box 32: specifying the liquidity management systems and procedures

Risks addressed / Policy objective:

Build-up of systemic risk in the financial system or risk of disorderly markets; funding liquidity risks; market liquidity risk; counterparty risk; Pro-cyclical herding behaviour in market downturns; unfair treatment of investors; mismatch between liquidity and redemption intervals

Scope Issues:

All open-ended funds and leveraged closed-ended funds

Option	Benefits	Costs	Evidence

Option 1 **Option presented in Consultation Paper in relation to liquidity management policies and procedures including a principles based approach in relation to the use of tools and arrangements** : AIFM are required to identify and disclose the types of circumstances where tools and arrangements will be used in both normal and exceptional circumstances taking in to account the fair treatment of investors	Diminishes herding behaviour. Diminishes revolving risk. Diminishes counterparty risk. Provides clarity for investors whilst providing AIFM's with flexibility to address changing market circumstances. Reduces the risk that tools and arrangements are utilised in inappropriate circumstances.	Increase in operational and funding costs.	Survey of firms, consultation responses.

Option 2 **Option rejected by ESMA in relation to liquidity management policies and procedures including a disclosure based approach in relation to the use of tools and arrangements** : AIFMs to put into effect the tools and arrangements, allowed under national law and regulation, necessary to manage the liquidity risk of each AIF under its management AIFMs may use these tools and arrangements to defer or restrict redemptions, provided that these tools and arrangements are used in a way that is consistent with the fair treatment of all AIF investors and appropriate disclosures have been made	Diminishes herding behaviour. Diminishes revolving risk. Diminishes counterparty risk. Provides investors with knowledge of tools and arrangements that may be utilised.	Increase in operational and funding costs. Risk of different interpretations by AIFMs and provided limited clarity to investors.	Survey of firms, consultation responses.
Option 3 **Option rejected by ESMA in relation to liquidity management policies and procedures including a prescriptive approach in relation to the use of tools and arrangements:** Approach combined prescriptive requirements in relation to the use of tools and arrangements in both normal and exceptional circumstances with disclosure. AIF rules to specify the actual circumstances, where such tools and arrangements should be used and what they deem to be normal and exceptional circumstances in relation to each AIF under management. AIFMs tot take in to account the fair treatment of all AIF investors in this process. Where AIFMs set limits, in relation to redemption or market circumstances, they shall only be able to use such tools and arrangements where such limits are exceeded	Diminishes herding behaviour. Diminishes revolving risk. Diminishes counterparty risk. Provides a higher level of certainty for investors as to the use of tools and arrangements to manage liquidity.	Increase in operational and funding costs. May limit AIFMs ability to respond to unforeseen circumstances if requirements are too prescriptive, therefore not acting in the best interests of investors.	Survey of firms, consultation responses.

6.2. Box 34: specifying the alignment of the investment strategy, liquidity profile and redemption policy.

Risks addressed / Policy objective

- Procyclical herding behaviour
- Effect of deleveraging on asset prices
- Mismatch between liquidity and redemption intervals

Scope Issues

Transversal but proportional or differentiated approach.

Option	Benefits	Costs	Evidence
Option 1 **Option presented in Consultation Paper in relation to the alignment of investment strategy, liquidity profile and redemption policy:** Specification of high level principle: The overarching principle is that investors should be able to redeem their investments in accordance with the AIF policy, which should cover conditions for redemption in both normal and exceptional circumstances, and in a manner consistent with the fair treatment of investors. When referring to the fair treatment of investors one of the factors that ESMA considers relevant is the impact on underlying prices and/or spreads of the individual assets of the AIF.	Diminishes liquidity risk and increases investor protection. Conveys importance of investments being selected that fit redemption policy. Enforces an obligation on AIFMs to act in a manner consistent with the fair treatment of investors.	Limits AIFM's investment options. Allows AIFMs discretion in the use of tools and arrangements to defer or restrict redemptions.	Survey of firms, consultation responses.

Option 2 **Option rejected by ESMA in relation to the alignment of investment strategy, liquidity profile and redemption policy:** Specification at detailed level: Overarching principle is that under normal circumstances redemption requests should be processed as they fall due, without materially impacting the underlying prices and/or spreads of the individual assets of the AIF.	Diminishes liquidity risk and increases investor protection. Highlights the importance of being able to meet redemption requests as they fall due without the need for fire sales. Limits AIFMs discretion in the use of tools and arrangements to defer or restrict redemptions which may not be consistent with the fair treatment of investors.	Limits AIFM's investment options.	Survey of firms, consultation responses.
Option 3 **Option rejected by ESMA in relation to the alignment of investment strategy, liquidity profile and redemption policy:** Extension of option 2 above to link to the liquidity management policies and procedures approach in relation to the use of tools and arrangements:	Diminishes liquidity risk and increases investor protection. Highlights the importance of being able to meet redemption requests as they fall due without the need for fire sales. Sets parameters for the use of tools and arrangements which should be consistent with the fair treatment of investors. Limits AIFMs discretion in the use of tools and arrangements to defer or restrict redemptions which may not be consistent with the fair treatment of investors.	Limits AIFM's investment options.	Survey of firms, consultation responses.

7. Investment in securitisation positions

Risks addressed / Policy objective

- Investor Protection
- Indirect regulation of systemic risk

Scope Issues

Little/no impact on private equity, real estate. Mainly relevant for hedge funds and money market funds.

7.1. Boxes 35-36-37 Requirements to be met by originator, sponsor, original lender, in order for an AIFM to be allowed to invest in securities

Option	Benefits	Costs	Evidence
Option 1 Taking into account relevant provisions of CRD including guidelines to Article 122a CRD as well as Solvency II and respective advice given (presented in consultation paper)	Level playing field with other financial institutions such as banks and insurance undertakings in order to achieve systemic stabilisation of securitisation industry. Strong obligation on AIFM to conduct thorough due diligence prior to investment therefore achieving indirect regulation of parties to the respective securitisation transaction. At the same time, overall systemic stabilisation of securitisation industry and due diligence prior to investment result in better investor protection.	Relevant costs due to specific complexity of securitised products will arise prior to every investment. Ongoing product innovations may require constant adaption of due diligence processes.	No further evidence needed as the existence of the regulatory regimes for financial institutions such as banks and insurance undertakings already sets standards. In order to prevent possibilities for regulatory arbitrage through use of fund investments it is necessary to adapt CRD and Solvency II rules to a great extent.

Option 2 Developing own regime for AIFM	'Tailor made' solution for AIFM could potentially be less burdensome (e.g. obligation to assess securitisations just according to rules applying to investments in equity etc.).	Risk of regulatory failure and arbitrage. Risk for investor protection and systemic stability.	

7.2. Boxes 38-39-40-41 Qualitative requirements to be met by an AIFM

Option 1 Implementation of specific organisational requirements (presented in the consultation paper)	Long term benefits for AIFM/AIF and investors due to proper assessment and on-going monitoring of specific risks related to securitised products. Implementation of adequate requirements for risk and liquidity management, monitoring procedures, stress testing and formal policies, procedures and reporting.	One-off costs for implementing the policy and procedures and running costs for review and possible adjustment of the process (for the AIFM and the regulator).	Financial crisis showed that risks of securitised products were underestimated.

Option 2 Treating securitisations like any other investment in transferable securities with respect to risk, liquidity management etc.	Short term benefits solely for AIFM/AIF due to less operational costs.	High risk for investors due to complexity of securitised products.	

8. Organisational requirements

Risks addressed / Policy objective

- Asymmetric information
- Investor Protections
- Market Integrity

Scope Issues

8.1. Box 44 to 54 General requirements on procedures and organisation (B.1-11)

Option	Benefits	Costs	Evidence

Option 1 Adapting the MiFID/UCITS L2 directive requirements (presented in the consultation paper)	Consistency with existing regulation. Also, overall it might be beneficial to implement a level playing field with other investment fund managers.	Low incremental costs since qualified fund managers already comply with organisational principles and UCITS managers have already to comply with respective rules.	

9. Valuation

Risks addressed / Policy objective

- Investor Protection

Scope Issues

- Valuation procedures apply to all types of AIFM.

9.1. Box 55 to 59 Policies and procedures for the valuation of the assets of the AIF

Option	Benefits	Costs	Evidence
Option 1 General criteria (presented in the consultation paper)	Minimum standard level for valuation procedures for all AIFM beneficial to investors (investor confidence). More flexibility to the AIFM.	One-off costs for implementing the policy and procedures and running costs for review and possible adjustment of the process (for the AIFM and the regulator).	
Option 2 Specific criteria for different assets	Minimum standard level for valuation procedures for all AIFM beneficial to investors (investor confidence). Specific criteria maybe helpful guideline to the AIFM.	One-off costs for implementing the policy and procedures and running costs for review and possible adjustment of the process (for the AIFM and the regulator). Risk of unsuitable design of regulation due to diversity of assets and investment strategies. Risk of infringement of Art. 19 which states that valuation of asset and the calculation of the NAV is up to national legislation.	

9.2. Box 60 Calculation of NAV per unit or share

Option	Benefits	Costs	Evidence
Option 1 NAV calculation at each subscription or redemption but at least once a year (presented in the consultation paper)	Ensuring a market standard for valuation at for the investors' relevant points in time. Level playing field with other investment funds.	Costs of implementation and ongoing calculation.	Similar rules for UCITS have been proven beneficial.

9.3. Box 61 Professional guarantees of external valuer

Risks addressed / Policy objective

- Investor Protection

Scope Issues

- Rules apply to all types of AIFM.

Options	Benefits	Costs	Evidence
Option 1 (presented in the consultation paper)	Independent valuation by a qualified external valuer is crucial to investor confidence. The specification of criteria for a qualified external valuer ensures good market practice for AIFM and helps to achieve a quality level among valuers. Standardized formal criteria for supervisors, that the valuation task is performed by a competent valuer.	Documentation cost to the AIFM.	

9.4. Box 62 Frequency of valuation carried-out by open-ended funds

Risks addressed / Policy objective

- Investor Protection

Scope Issues

- Rules apply to open-ended funds only.

Options	Benefits	Costs	Evidence
Option 1 General rules for all assets other than financial instruments (presented in the consultation paper)	Minimum standard level for valuation procedures for all AIFM is beneficial to investors (enhances investor confidence).	Low incremental costs since qualified fund managers already comply with valuation rules.	Similar rules for UCITS have been proven beneficial to investors.
Option 2 Specific rules for different assets other than financial instruments	Higher frequency of valuation for some types of instruments could be beneficial to investors.	Risk of unsuitable design of regulation due to diversity of assets.	

10. Delegation

Risks addressed / Policy objective

- Investor Protection
- Market Integrity

Scope Issues

10.1. Box 63 and 64: General principles

Option	Benefits	Costs	Evidence
Option 1 Adapting the MiFID L2 directive requirements (presented in the consultation paper)	Consistency with existing regulation. Also, overall it might be beneficial to implement a level playing field with other investment fund managers and other market players.	One-off costs for implementing delegation principles and running costs for management of delegation risks.	Grown importance of delegation in the financial sector.

10.2. Box 65: Objective reasons

Options	Benefits	Costs	Evidence
Option 1 General principle for justification of delegation (presented in the consultation paper)	Consistency with existing UCITS provisions. More flexibility for AIFM.	Incremental costs of self-assessment.	
Option 2 List of examples for objective reasons.	More detailed guidance for self-assessment of AIFM regarding objective reasons.	Incremental costs of self-assessment.	

10.3. Box 66 Sufficient resources and experience, sufficiently good repute

Risks addressed / Policy objective

- Investor Protection
- Market Integrity

Scope Issues

Option	Benefits	Costs	Evidence
Option 1 Definition of general circumstances (presented in the consultation paper).	More detailed guidance for self-assessment of AIFM regarding delegates. Better supervision of selection of delegates as a precondition for the proper functioning of AIFM.	One-off costs for implementing selection criteria and running costs for monitoring of compliance.	Grown importance of delegation in the financial sector.

10.4. Box 67 Eligible institutions authorised or registered for asset management and subject to supervision

Risks addressed / Policy objective

- Investor Protection
- Market Integrity

Scope Issues

Option	Benefits	Costs	Evidence
Option 1 General criteria for eligible institutions (presented in the consultation paper).	More flexibility, judgement of each case on its own merits. No differentiation between delegates in EU and in third countries.	Higher costs for evaluation of eligibility.	
Option 2 Specific categories for eligible institutions.	Where possible, more detailed guidance for AIFM with the benefit of less uncertainty about eligible delegates.	Risk of too restricted choice of delegates and therefore strong regulatory influence on business models.	No suitable categories in third countries due to diversity of regulation and supervisory standards.

Option 3 Mixed approach: specific categories for EU delegates and general criteria for third countries (presented in the consultation paper).	Optimisation of option 1 and 2.	One-off costs for implementing selection criteria and running costs for monitoring of compliance.	Grown importance of delegation in the financial sector.

10.5. Box 68 Effective supervision of AIFM and AIFM acting in the best interest of its investors

Risks addressed / Policy objective

- Investor Protection
- Market Integrity

Scope Issues

Option	Benefits	Costs	Evidence

Option	Benefits	Costs	Evidence
Option 1 (presented in the task force paper).	Consistency with MiFID regulation. Prevents AIFM from circumventing AIFMD by outsourcing to delegates in third countries where home supervisor has no powers to access premises or data.	Incremental costs for adapting outsourcing agreements.	Already market standard for investment firms.

10.6. Box 71 Criteria for identification and management of conflicts of interests

Option	Benefits	Costs	Evidence
Option 1 General criteria (presented in the task force paper)	Guidance for AIFM and regulators by specific examples. More transparency and investor confidence. Awareness of the AIFM in relation to identification of conflicts of interests between AIFM/investors of AIF and delegate/sub-delegate should lead to enhancement of market integrity.	Costs for implementing functional and hierarchical separation. Running costs for monitoring of compliance.	Market standard for delegates which are (MiFID) investment firms.

10.7. Box 73 Letter-box entity

Risks addressed / Policy objective

- Investor Protection
- Market Integrity

Scope Issues

General principle applies to all AIFM.

Option	Benefits	Costs	Evidence

Option	Benefits	Costs	Evidence
Option 1 Conditions for assessment of letter-box entity (presented in the consultation paper).	Guidance for AIFM and regulators. More transparency and investor confidence.	Running costs for monitoring of compliance.	

11. Contract evidencing appointment of the depositary

Objectives and underlying problems

In order to improve investor's protection and confidence, it seems important to reduce weaknesses in the relationship between the depositary and the AIF or the AIFM. Thus, the AIFMD text requires the appointment of the depositary to be evidenced by a contract in writing. In this perspective, ESMA is:

i. requested to advise the Commission on the necessary particulars to be found in the standard agreement evidencing the appointment of the depositary. In its advice, ESMA should take into account the consistency with the respective requirements in the UCITS Directive;

ii.encouraged to provide the Commission, if possible, with a draft model agreement.

Options, impact and comparison

11.1.Box 74 Determining the particulars that need to be included in the standard agreement (Box 1 of the AMF paper)

ESMA has to determine the particulars that need to be included in the standard agreement as referred to in paragraph 2. ESMA considered three options: i) reusing the requirements of the UCITS directive which defines the minimum elements of the contract; ii) adapting the UCITS directive requirements and adding specific provisions applicable to AIF depositaries; and iii) designing something specific to AIFMD.

Consultation of the industry showed that many depositaries offer services to both UCITS and AIF using separate appointment processes. Nevertheless, distinguishing the appointment contracts according to the legal type of funds (UCITS or AIF) is less relevant than a distinction according to the asset classes of the fund. AIFs can invest in a wider range of asset classes than UCITS. This means that AIFs may invest in similar asset classes as UCITS funds but also in some other assets classes not covered by UCITS Directive. As a consequence, there does not seem to be additional costs of inspiring implementing measures of AIFMD from the UCITS Directive and its implementing measures on this topic. However, some adaptation is needed to deal with the specificities of AIFs; for instance, the larger range of asset classes as already mentioned.

Reusing the requirements of the UCITS directive which defines the minimum elements of the contract would ensure the maximum level of consistency between Directives. However, it would not deal with the specificities of AIFM.

Adapting the UCITS directive requirements and adding **specific provisions applicable to AIF** depositaries would not only provide consistency between Directives but also a tailoring to AIF specificities. Nevertheless, it may induce a slight increase in costs because of the adaptation task.

Designing something **specific to AIFMD** would ensure to deal with all the specificities of AIF. However, there is a risk of inconsistency between Directives. In addition, the cost of adaptation would be much higher.

Option 2 Policy options	Benefits	Costs	Evidence needed
Option 1 Adapting the UCITS directive requirements and adding specific provisions applicable to AIF depositaries	Consistency with existing regulation Regulation tailored to AIF specificities	Risk of missing some issues specific to AIF	
Reusing the requirements of the UCITS directive which defines the minimum elements of the contract	Consistency with existing regulation	Slight increase in costs	

Option 3 Innovating by designing something specific to AIFMD	Regulation tailored to AIF specificities	Risk of inconsistency between Directives creating regulatory arbitrage opportunities Large administrative burden	

In light of this analysis, it seems that adapting the UCITS directive requirement and adding specific provisions applicable to AIF depositaries is the most appropriate option to determine the particulars needed to be included in the standard agreement.

11.2. Designing a model agreement

ESMA has to decide whether to provide a model agreement for the appointment of the depositary or not.

Establishing a model agreement would provide a more harmonized supervisory approach. In the same way, it would reduce the uncertainties in understanding rules, thus lowering the risk of non-compliant behaviours or models. However, such an option would imply a very high degree of rigidity and it is very unlikely that a single model of contract can be relevant for the large number of different business models and legal environments. In addition, the provisions contained in ESMA's answer to the request, combined with the requirements detailed in the level one text, provide a strong regulatory framework which would not be enhanced by imposing a model agreement.9999 Indeed, the potential saving resulting from having a standardized model agreement seems to be inexistent.

Not providing a model agreement would preserve the adaptability to a large range of different business models and legal environments. The risk of having a lower degree of harmonization would be mitigated, to a large extent, by providing the minimum content of the contract and some common approach on its main

elements. In addition, it should be noted that CESR (now ESMA) decided not to recommend developing a model agreement in the framework of the UCITS Level 2 measures.

Policy options	Benefits	Costs	Evidence needed
Option 1 Establishing a model agreement	Higher degree of harmonization Higher legal certainty	High degree of rigidity and impossibility to be relevant for all types of AIF No potential saving from having a standardized model agreement	
Option 2 Not providing a model agreement	Preservation of the adaptability to a wide range of business models and legal environments Consistency with Level 2 of UCITS Directive	Risk of having a lower degree of harmonization	

A comparison of the costs and benefits of the different options underlines that it may be preferable not to establish a model agreement for the appointment of a depositary, especially if consistency with the recommendation for UCITS Level 2 measures is desired.

12. Depositary functions

In order to specify the conditions for performing the depositary functions pursuant to paragraphs 7, 8 and 9 of Article 21, ESMA is requested to discuss the potential impacts of different options for the types of financial instrument to be within the scope of custody duties on costs and on the level of investor protection.

12.1. Depositary functions – cash monitoring

12.1.1. Objectives and underlying problems

In order to reduce micro-prudential risk and foster market efficiency, the AIFMD text states that the depositary must ensure that the AIF's cash flows are properly monitored by the depositary. To make this cash monitoring as efficient as possible, ESMA is requested:

i. to specify the conditions for performing the depositary functions pursuant to paragraphs 7

ii. to specify the conditions applicable in order to assess whether an entity can be considered to be of the same nature as the entity referred to in Article 18 (1) (a) to (c) of Commission Directive 2006/73/EC, [...] and whether such an entity is subject to effective prudential regulation and supervision to the same effect [...]

iii. to specify the conditions applicable in order to determine what shall be considered as the relevant market where cash accounts are required.

12.1.2. Options, impact and comparison

12.1.2.1. Determining the category of asset to which cash belongs

As a preliminary step of its advice on cash monitoring, ESMA has reflected on the category of asset to which cash belongs. Three options were considered by ESMA: i) considering cash as an asset to be held in custody; ii) considering cash as an asset subject to record keeping but with specific requirements for cash monitoring; and iii) considering cash as a third type of assets and developing specific requirements for cash monitoring.

First, it has to be noted that costs and benefits of cash monitoring would rather depend on the decision made in the following paragraphs dealing with the regime for cash monitoring. Then it has to be stressed that cash cannot be legally considered as a financial instrument, thus it cannot be subject to custody under the definition of the Directive. In this perspective, considering cash as an asset subject to record-keeping would provide an equal treatment of the 'other assets'. However, cash presents some specific characteristics, among which the fact that when it is deposited, it bears a counterparty risk with regard to the entity to which the cash has been entrusted. Because of these specificities, it seems reasonable to develop specific requirements for cash monitoring.

As a consequence, the most suitable option is to consider cash as an asset subject to record-keeping but with specific requirements.

12.1.2.2. Specifying the conditions for performing the depositary functions of cash monitoring

a) Flow of information

ESMA has to suggest regulation about the flow of information the depositary receives in order it to be in a position to properly perform its cash monitoring functions. Only one option has been considered but it has to be assessed in comparison to not providing any advice on this point.

ESMA considered requiring that the depositary is informed at three different stages: first, upon its appointment, it is informed of all existing cash accounts with third parties; second, it is informed prior to the opening of a cash account with a third party; and finally, it receives all relevant information in order to appropriately monitor all the AIF's cash flows related to cash accounts opened at third party entities directly from those third parties.

Given that the depositary has limited ability to detect the various accounts mentioned, such a requirement would tackle micro-prudential risks by reducing the operational risk. In addition, by ensuring a higher degree of information to the depositary, it would foster investor protection. Nevertheless, such a requirement would entail incremental costs to depositaries; AIFM and third parties for implementing adequate procedures to broadcast receive and process the generated information. It has to be stressed that such procedures already exist in some Member States because it is required by the national regulation or because it is the current best market practice.

Box 75

Policy options	Benefits	Costs	Evidence needed
Option 1 The depositary: - is informed upon its appointment of all existing cash account with third parties; - is informed prior to the opening of a cash account with a third party; and - receives all relevant information in order to appropriately monitor all the AIF's cash flows.	Appropriate control of the operational risk Appropriate control and processes to ensure the depositary has all the relevant information.	Incremental cost to depositaries, AIFM and third parties for implementing adequate procedures (no additional cost in some Member States)	Feedback from the industry about the incremental costs

In a word, the proposed requirements which aim at ensuring that the depositary receives the flow of information necessary to perform its cash monitoring duties appears to be highly relevant.

b) Cash monitoring

ESMA has to deal with how the depositary ensures all the AIF's cash flows are accurately monitored. Four options were considered by ESMA: i) ex-ante authorization; ii) prior information iii) daily reconciliation of all cash flows; and iv) ex-post monitoring.

An **ex-ante authorization** regime, by which the depositary would sign off every cash flow instruction, would strongly reduce operational risks by providing a maximum control over cash. In such a regime, the double signature requirement (AIF/AIFM and depositary) would also reduce the possibility of pending transactions and facilitate the implementation of proper monitoring duties by the depositary. Moreover, 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 the 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 hinders a timely execution of operations which make it hardly workable in practice when the frequency of the transactions is high. 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. 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. 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 costs for the industry.

A **prior information** regime would require the AIFM to simultaneously send information to the depositary and the instruction to the third party when it wants to dispose of the cash account. In the same way, the third party informs 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 without much of the cost associated to the ex-ante authorization regime. For instance, there would only be a limited impact on the execution of operations and settlement. However, the risk that the number of transactions to check is beyond the ability of the depositaries would remain.

Requiring **a 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 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 while such a duplication of tasks may only bring little added value. Costs related to this regime would depend on the modality of the reconciliation. First, costs will depend on the level of detail required for the reconciliation. Second, the more frequent the reconciliation has to be performed; the more costly it would be for the depositaries and ultimately for the investors. Besides, as already pointed out in the discussion on the ex-ante authorization, the depositary is unlikely to be privy to intra-day information regarding cash movements held in accounts with third parties. That is why, according to the industry, it would be unworkable to reconcile all cash movement on the AIF's relevant cash accounts against all individual trade transactions given by the AIFM, on a daily basis.

An **ex-post monitoring** would provide a high degree of flexibility and be more workable for an efficient investment process. It would require relatively lower implementing costs to the depositaries, AIFM and third parties than the other options. That is why the industry strongly expressed its preference for this option during the targeted engagement organised on 11th March 2011. However, a higher operational risk would remain since there is no control by the depositary over cash flows in and out of accounts opened at third party entities. It is also possible that such a regime could imply some duplication of work already undertaken by the auditors. To counter those drawbacks, ESMA has suggested additional requirements to strengthen the monitoring requirement under that option. In particular, the depositary would have to ensure 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.

Box 76

Policy options	Benefits	Costs	Evidence needed
Option 1 Ex-ante authorization	Maximum control over cash. Strong prevention of fraud and pending transactions. Limitation of circumvention practices.	Slowing down of the transactions. Additional risk of missed settlement. Large implementation cost (infrastructure and resources). Increase in systemic risk	
Option 2 Prior information	High level of oversight over cash flows. Lower implementing cost.	Risk of having too many transactions to check.	
Option 3 Reconciliation of all cash flows	Mitigation of operational risk. Reduction of the risk of fraud and pending transactions.	Cost of storing the information generated. Duplication of tasks already performed with little added value.	

Option 4 Ex-post monitoring	High degree of flexibility allowing an efficient investment process. Lower implementing costs for depositaries.	Lack of ex ante control over cash flows.	

ESMA has decided to consult on two options. First, an option inspired from the prior information regime refined to include a requirement to mirror the transactions of the cash accounts into a position keeping system. This updated option would make the depositary act as a central hub. Second, a strengthened ex-post monitoring regime including requirements such as an obligation to fully review the reconciliation process at least once a year would also be subject to consultation.

c) Duties regarding subscriptions in the AIF

ESMA has carefully considered how to clarify the AIFMD requirement with regard to the depositary's responsibility concerning investor subscriptions. ESMA's opinion is that the depositary is not required to make verifications along the distribution channel but rather to focus on the subscription proceeds that actually reach the AIF.

ESMA considered three options: i) requiring the depositary to ensure the cash received upon the subscription of shares or units of an AIF is booked in an account opened at the depositary; ii) requiring the depositary to ensure that a reconciliation between the subscription proceeds/redemption with the number of units or shares created/cancelled is performed and check the consistency between the number of shares or units in the AIF's account and the total number of outstanding shares or units in the central register; and iii) add a requirement to ensure that a reconciliation between the subscription commitment and the subscription proceeds is performed.

Requiring the depositary to ensure the cash received upon the subscription of shares or units of an AIF is **booked in one of its account** would allow it to have a stronger oversight and to be better informed. No prior authorization would be required but the information would be available at all time. The obvious consequence would be a higher level of protection of the AIF and its existing investors by reducing the likelihood of the AIF having to bear the cost of the potential loss when disinvesting the amount corresponding to the proceeds that were expected from new investors' cash. However, such a requirement would lead to a dramatic reshaping and limitation of the distribution channels. In addition, it is a restrictive approach of the AIFMD text.

A second option would require the depositary to perform two tasks. First, it would have to ensure that the AIF, the AIFM or the appointed entity effectively **reconciles the subscription proceeds/redemptions with the number of units or shares issued/cancelled**. Second, it would have to regularly **check the consistency between the number of shares or units in the AIF's account and the total number of outstanding shares** or units in the central register. This option would be adapted to the existing distribution channels and thus would involve

limited implementation costs. However, the degree of access to information for the depositary would be reduced compared to the option requiring that the cash received upon subscription is booked in an account opened at the depositary.

A third option consists in adding a requirement that the depositary ensures that **reconciliation between the subscription commitment and the subscription proceeds** is performed. This option would ensure a proper booking of the subscription proceeds. However it would imply additional costs for the depositary.

Box 82

Policy options	Benefits	Costs	Evidence needed
Option 1 Ensure the cash received upon the subscription of shares or units of an AIF is booked in an account opened at the depositary.	Better information of the depositary at all time. Stronger oversight by the depositary.	Limitation of the distribution channel. Restrictive interpretation of the AIFMD text.	
Option 2 - Ensure the AIF, the AIFM or the appointed entity effectively reconciles the subscription proceeds/redemption with the number of units or shares created/cancelled. - Check the consistency between the number of shares or units in the AIF's account and the total number of outstanding shares or units in the central registrar's registry.	No need to modify the distribution channels.		

Option 3 Additional requirement: Ensure that a reconciliation between the subscription commitment and the subscription proceeds is performed	Insurance of proper booking of the subscription proceed.	Additional costs.	

A comparison of the costs and benefits of the different options underlines that the requirements provided in option 2 appear as sufficient to achieve the desired level of investor protection at the most acceptable cost.

d) Conditions for ensuring the AIF's cash is properly booked (Box X. box 4 of the AMF paper)

ESMA has to suggest how to make sure the depositary ensures that all the AIF's cash has been booked correctly, in accordance with the provisions set forth in Article 16 of Directive 2006/73/EC. ESMA considered two options: i) not specifying any additional requirement; and ii) requiring that the depositary check that the AIFM complies on an on-going basis with the requirements of Directive 2006/73/EC (MiFID) in relation to cash.

Since the AIFMD text already refers to MiFID Directive, ESMA considers that, to ensure the AIF's cash is properly booked, the depositary is required to check the AIFM complies on an on-going basis with the requirements of Directive 2006/73/EC in relation to cash.

12.1.2.3. Assessing whether the entity is of the same nature as the entity referred to in Article 18 (1) (a) to (c) of Directive 2006/73/EC

a) Precision of the assessment

To respond to this request and provide some clarification, ESMA considered two alternative options: i) indicating which kind of entities can be considered to be of the same nature; ii) not providing any additional precision.

The first option **limits the entities which can be considered of the same nature to entities referred to in Article 18 (1) (a) to (c) of Directive 2006/73/EC to banks or credit institution**. This restriction to relatively better supervised institutions enables to reduce the systemic risk more strongly. Although such a degree of precision reduces flexibility by reducing the type of entities that could comply with the requirement, a closed list improves the harmonization between jurisdictions.

Not providing additional requirement to the AIFMD definition provides a large degree of flexibility and would lead to include a larger range of entities among those considered as of the same nature as the entity referred to in Article 18 (1) (a) to (c) of Directive 2006/73/EC. Nevertheless, it fails to reduce micro-prudential and systemic risks since there is no certainty about the type of entities that can comply with the requirements. Moreover, it leaves the room open for different interpretations across jurisdictions.

A comparison of the costs and benefits of the different options leads ESMA to suggest that an entity of the same nature as entities referred to in Article 18 (1) (a) to (c) of Directive 2006/73/EC should be understood as a bank or a credit institution.

12.1.2.4. Relevant market where cash accounts are required

ESMA interpreted 'relevant market where cash accounts are required' as the countries located outside Europe and where the AIF opens an account because of its investment strategy.

12.2. Depositary functions – safe keeping duties

12.2.1. Objectives and underlying problems

In order to reduce the default risk and increase investor protection and confidence, the AIFMD imposes to entrust AIF assets to the depositary appointed to perform safe-keeping duties. Such duties can take the form of custody or record-keeping. The AIFMD text provides a hi-level definition of assets to be held in custody and the associated custody regime. In the same way, it states that other assets should be subject to a record-keeping regime. To clarify these safe keeping duties, ESMA is requested:

i. to advise on the type of financial instruments that shall be included in the scope of the depositary's custody duties and the conditions applicable to the depositary when exercising its safekeeping custody duties for such financial instruments;

ii. to advise on the type of 'other assets' and the conditions applicable to the depositary when exercising its safekeeping duties over such 'other assets';

iii. to advise on the conditions upon which the depositary shall verify the ownership and the information, documents and evidence upon which a depositary may rely to perform such a task; and

iv. to considering the circumstances where assets belonging to the AIF, are subject to temporary lending or repurchase arrangements or any type of arrangements under which financial instruments may be re-used or provided as collateral.

12.2.2. Options, impact and comparison

12.2.2.1. Determining the scope and regime for custody

a) Means for determining the type of financial instruments that should be held in custody (Box X, Box 5 of the AMF paper)

Determining the type of financial instruments that should be held in custody involves two main issues. The first one is to define what 'financial instruments' are. ESMA relied on MiFID which provided a harmonized European framework on this point. The second issue is to determine, among these financial instruments, those which should be subject to custody. ESMA considered two options: i) establishing a list (limitative or indicative); and ii) providing a more detailed definition of the financial instruments that should fall into the definition of Article 21 (8) (a).

Establishing a limitative list of financial instruments which are included in the scope of the depositary's custody duties provides simplicity and clarity. However, such a form creates some uncertainty when a financial instrument does not clearly fall inside or outside the list. A main drawback of this option is its lack of flexibility. If the range of financial products evolve over time, it is very likely that the list would become obsolete.

Establishing clear criteria to identify the financial instruments to be held in custody would allow for more flexibility. As a consequence, such an option is more likely to capture specific cases, even those which can lead to different interpretations provided the definition is detailed enough.

A comparison of the costs and benefits of the different options shows that clear criteria is the most appropriate form to determine which type of financial instruments should be held in custody.

b) Definition of financial instruments to be held in custody (Box 78)

A second step for ESMA is to suggest which criteria shall be used to define 'financial instruments to be held in custody'. The idea of control by the depositary was at the core of ESMA's discussions. ESMA considered three options: financial instruments subject to custody can be financial instruments belonging to the AIF i) which are settled through a Central Securities Depository; ii) which are registered through a settlement system as defined by Directive 98/26/EC or a system deemed equivalent; or iii) which can be registered directly or indirectly in the name of the depositary.

Considering financial instruments to be held in custody as financial instruments which are settled through a CSD would be a very clear and sensible definition. However, two main issues may make a definition based on this criterion unworkable. First, only 60 countries in the world have a CSD, so the criteria would not apply to a majority of markets. Second, among the 60 countries having a CSD, the interpretation of what a CSD is can considerably vary. Although a Directive on CSD is expected, the notion of CSD has not yet been harmonised at a European level.

Considering financial instruments to be held in custody as financial instruments that are settled through a settlement system or a system deemed equivalent would provide clarity by relying on a notion harmonized at the European Level. Directive 98/26/EC provides a clear interpretation of what is designated as a settlement system. However, such a definition would entail difficulties with respect to non-European markets, where the Directive does not apply. It may be hard to define precisely which systems are deemed 'equivalent' because it is unclear who is entitled to decide and according to which criteria.

Considering financial instruments to be held in custody as financial instruments belonging to the AIF and registered directly or indirectly in the name of the depositary would provide a clear definition. The depositary's liability would be clearly linked to all financial instruments for which only the depositary can instruct a transfer of title. It would also leave flexibility for the AIF since it can operate a trade-off and choose the most suitable regime: custody or record-keeping.

Box 78 Definition of financial instruments to be held in custody

Policy options	Benefits	Costs	Evidence needed
Option 1 Financial instruments which are settled through a CSD	Clarity	Notion of CSD not harmonized across Member States Large number of countries without a CSD	
Option 2 Financial instruments that are settled through a settlement system or system deemed equivalent	Rely on a definition harmonized at the European level	Difficulty to define a system deemed equivalent	
Option 3 Financial instruments belonging to the fund and registered directly or indirectly in the name of the depositary	Flexibility for the AIF (choice between custody and record-keeping) Clear link between the depositary's liability and the ability to instruct a transfer		

A comparison of the costs and benefits of the different options only enables to rule out option 1. Thus, it seems reasonable to consult on both options 2 and 3.

c) <u>Means for determining conditions applicable to custody duties</u>

To determine the conditions applicable to custody duties, ESMA considered two options: i) Defining precisely the tasks; or ii) defining criteria that the depositary must ensure to be respected.

A **precise definition of the tasks** to be performed by the depositary boils down to adopting a 'box-ticking' approach. Although it provides a simple common framework, a 'box ticking' approach tends to be more of a quantitative than a qualitative exercise. So, there is a high risk that custody duties are not performed properly. Moreover, it creates a monitoring cost to ensure that the list of tasks is still consistent with the evolution of the market practice. Finally, a list of tasks entails the danger that, in certain circumstances, a depositary would rely on the list as a minimum standard while further action would be required.

Defining some criteria and requiring the depositary to ensure that they are respected appears as a more flexible approach. Creating a responsibility to achieve an outcome for the depositary rather than a best effort undertaking fosters the development of procedures and processes, thus, stressing the importance of governance, monitoring duties and oversight functions for the depositary. The depositary has to demonstrate that it did not limit its efforts to ticking boxes, so investor protection is reinforced. Nonetheless, such a way to determine custody duties bears a larger monitoring cost since it is more demanding to monitor a series of tasks that are not standardised.

A comparison of the costs and benefits of the different options underlines that defining the criteria the depositary should ensure to be respected is the option that is the most relevant.

12.2.2.2. Determining the scope and regime for 'other assets'

a) Approach to determine the type of 'other assets'

ESMA has to decide which approach to take in order to determine the type of 'other assets''. ESMA considered two options: i) a positive definition of 'other assets'; and ii) an *a contrario* approach iii) potentially complemented by a non-exhaustive list in the explanatory text.

Defining the 'other assets' in the same positive manner as done for the assets to be held in custody would provide clarity. Nevertheless, there is a great risk that some assets escape from either one or the other regime. Such kind of loophole would be very harmful for the concrete application of the Directive.

An ***a contrario* approach** would consist in considering as 'other assets' the assets that are not included in the scope of the depositary's custody duties provides clarity and meanwhile, provides a sufficient degree of flexibility to ensure that the entire range of financial instruments is covered.

Complementing this '*a contrario*' approach by a **non-exhaustive list** of assets considered as 'other assets' would provide useful guidance while maintaining a large degree of flexibility.

A comparison of the costs and benefits of the different options stresses that an 'a contrario approach' complemented by a non exhaustive list of 'other assets' would be the best way to determine the type of 'other assets'

b)Form of the conditions applicable to safekeeping of 'other assets'

ESMA has to suggest how to determine the conditions applicable to the safekeeping of 'other assets'. ESMA considered two options: i) defining precisely the tasks; and ii) defining criteria that the depositary must ensure to be respected.

A **precise definition of the tasks** to be performed by the depositary consists in a 'box-ticking' approach. Although it provides a standardized and easy to understand approach, there is a risk that it becomes only a quantitative exercise and lacks the qualitative approach desired. Moreover, it is very likely that the list quickly becomes obsolete because of the evolution of the market practice. Such a threat creates a monitoring cost to ensure that the list of tasks remains consistent after its publication. Finally, a list of tasks entails the danger that, in certain circumstances, a depositary would rely on the list as a minimum standard while further action would be required.

Defining some criteria and requiring the depositary to ensure that they are respected provides more flexibility. Creating a requirement to meet a specific objective rather than a best effort obligation fosters the development of procedures and processes. It obliges the depositary to better deal with governance, monitoring duties and oversight functions. Nonetheless, such a way to determine record keeping duties bears a larger monitoring cost since it is more demanding to monitor a series of tasks that is not standardised.

A comparison of the costs and benefits of the different options underlines that defining general principles is the option that is the most likely to achieve the desired result.

c) Regime for 'record keeping' of 'other assets' (Box 80)

The record keeping task of other assets implies a double requirement. First, the depositary should verify the AIF's ownership of assets. Second, when the ownership has been ensured, the depositary should keep a record of the assets so as to be in a position to provide upon request a complete inventory of all the AIF's assets at all time. To achieve this objective, the depositary may have several alternatives. ESMA considered two options: i) a strict oversight of all transactions; and ii) mirroring all transactions in a position keeping record.

To comply with a requirement of a **strict oversight of all transactions**, the depositary could either design procedures to ensure that assets cannot be assigned, transferred exchanged or delivered without its prior information; or obtain documentary evidence of each transaction on a timely basis. This option would provide a high degree of flexibility and enables the depositary to adapt its record keeping to the practice of different types of funds. When it is feasible (e.g. infrequent transactions and/or transactions which are subject to pre-settlement negotiation), prior information of the depositary could be required regarding the transaction. In the other cases including more frequent portfolio trading, the depositary would be required to obtain documentary evidence of each transaction thus relying on third party records. As a consequence, this regime would ensure that the depositary is aware of all transactions happening, so it would provide a higher degree of security.

Requiring the depositary to **mirror all transactions** in position keeping records/accounts would allow the depositary to have a clear view of all the assets of the AIF at all times in one and single record updated by the depositary itself. It would be in a position to provide upon request a complete inventory of all the AIF's assets. To be able to mirror all transactions, the depositary will have to set up appropriate procedures and roll out systems which could imply significant implementation costs for the industry.

Box 80 Record keeping regime

Policy options	Benefits	Costs	Evidence needed
Option 1 Strict oversight of all transactions	Flexibility to adapt the record keeping to different types of assets.	Reliance on third party's data.	
Option 2 Mirroring all transactions	All information related to the AIF's portfolio kept on a single record at the depositary.	Implementing costs of changing the technology system.	

A comparison of the costs and benefits of the different options does not clearly lead to rule out one of them. Thus, ESMA decided to consult on both options.

12.2.2.3. Determining the conditions for verifying the ownership of assets

a) Form of the requirement (Box X, see Box 7 AMF paper)

ESMA has to propose which form is the most appropriate for the requirement stating that the depositary has to verify ownership of the AIF, or the AIFM on behalf of the AIF, on the assets. ESMA considered four options: i) an exhaustive list; ii) a non-exhaustive list; iii) principles; and iv) considering that the AIFMD text is sufficient and not providing any advice.

Defining an **exhaustive list of tasks** to be carried out by the depositary would provide clarity and simplicity. However, it bears a risk of becoming obsolete as soon as new financial products are developed. Moreover, it may be considered as a minimum standard by the depositary. The latter would only carry out this standard while further action would have been needed. In any case, such a requirement would raise operational costs as it creates a duplication of functions with the manager's administration or the fund's accounting records.

Defining a **non-exhaustive list of tasks** would provide more or less the same benefits and costs as an exhaustive list. The requirements may also be interpreted as a minimum standard to be carried out by the depositary even though further action would be necessary.

Establishing **principles** based on which it will be possible for the depositary to verify the ownership would provide more flexibility. As a consequence, it allows dealing with more diverse cases, even those which were not foreseen when drafting the requirements. It is also possible to expect that having principles will foster the development of processes stressing the importance of governance, monitoring duties and oversight functions. Nonetheless, such an option implies a higher monitoring cost since it is more difficult to monitor procedures that are not standardized. Like the previous options, establishing principles may lead to a duplication of function with the manager's administration or the fund's accounting record, thus raising operational costs.

Considering that the AIFMD is sufficiently detailed and therefore **not providing any advice** on this question does not create any incremental cost. There is neither extra monitoring cost for the regulators, nor additional implementation cost for the AIFM. Nevertheless, the practice and the recent turmoil have shown that guidance, in any form, is highly recommended on this topic.

ESMA has considered that it would not be possible to cover in general terms all possible situations and that consequently, it was not desirable to define precisely the type of documents the depositary should rely on to satisfy itself that the AIF or AIFM holds ownership over the asset either by establishing a list of possible documents or by providing strict criteria. ESMA believes that given the broad range of assets in which an AIF may invest, the depositary should assess on a case by case basis whether the evidence it is provided with is sufficient and where relevant ask for additional documents. However, ESMA could consider developing guidelines if there is a need for further guidance.

b) Regime for nominee accounts

Where the assets are registered directly with the issuer or registrar (for example when an AIF decides to invest in a target fund), the depositary can register the assets either directly in the name of the AIF, in its own name 'on behalf of the AIF' or simply in its own name on behalf of a number of unidentified clients (hereafter referred to as 'nominee accounts'). Registering ownership in a nominee name may be motivated by a large number of different purposes; for instance: confidentiality, operational efficiency, sub-custodian facilitating the investment when the minimum amount is significant, etc.

ESMA is aware that a clarification of the regime for nominee accounts may have implications on the organization of the market. ESMA considered three options for the requirement related to assets held in a nominee account: i) to be subject to the custody regime; ii) to be subject to record keeping without additional requirement; and iii) to be subject to record keeping with additional requirements. Requiring the assets held in nominee form to be subject to custody would clarify the market possibilities.

If the assets are registered in the name of the AIF or in the name of the depositary acting on behalf of the AIF, the AIF would be clearly identified as the owner of the assets which would be subject to record keeping. Where the AIF is not identified in the register as the owner and the financial instruments are registered in the name of the depositary only, they would be subject to custody and the depositary would be liable in case of loss. This mechanism would leave flexibility to the AIF. By choosing whether to register the financial instruments in a nominee form or not, the AIF would operate a trade-off between, on the one hand, the protection provided by the depositary's liability with respect to the financial instruments

held in custody, on the other hand, the increased fees potentially requested by the depositary and the more little room to exercise its rights over the assets.

Requiring the assets held in nominee form to be subject to record keeping would maintain a status quo and not increase the cost the industry. The current market practice would be maintained. However, it would not provide any improvement to the situation, especially it would not clarify the different implications of the decision of opening in the nominee form or not.

Requiring the assets to be subject to record keeping but with specific duties imposed on the depositary (in particular the depositary would be required to inform the AIFM of the implications of not being the registered owner and to take all appropriate measures to ensure the AIFM can exercise its rights over the assets if a problem arises which impacts those assets for which the depositary is the registered owner of the shares in the issuer's register or with a registrar) would make it possible to deal with the specificities of nominee accounts (see Boxes 78 and 81).

Boxes 78 and 81 Regime for nominee accounts

Policy options	Benefits	Costs	Evidence needed
Option 1 Custody duties	Clarification of the market. Flexibility for the depositary to choose the regime most advantageous.		
Option 2 Record keeping with no additional requirement	In line with current market practice.	Status quo maintained (no clarification of the market).	
Option 3 Record keeping with specific duties	Consistency with nominee accounts specificities.	Lower degree of clarification of the market.	

12.2.2.4. Determining the conditions for situations where the assets for safekeeping are subject to temporary lending or repurchase arrangements or any type of arrangements under which financial instruments may be re-used or provided as collateral

a) Criteria to distinguish the different situations that can be encountered (Box 79)

ESMA has to recommend which criteria are the most relevant to distinguish the different situations involving assets provided as collateral. More precisely, it has to determine criteria excluding the assets from the custody regime. ESMA considered three options: i) a distinction on whether there is a transfer of ownership; ii) a distinction based on two criteria (transfer of ownership and transfer of the assets out of the depositary's books); and iii) considering that no distinction is needed and that by definition, assets provided as collateral are subject to record keeping.

Considering that assets provided as collateral and subject to a transfer of ownership are outside of the scope of custody would provide some clarity. It would be consistent with market practice in some European countries and in the United States. However, for other countries, significant adaptations would be needed. Besides, although the Collateral Directive provides a clear definition of the 'title transfer financial collateral arrangements'[48], there is no harmonization among the Member States regarding the right of ownership. This partial degree of harmonization entails some risk of different interpretations across Member States.

Considering that assets provided as collateral, subject to a transfer of ownership and a transfer out of the depositary's book are outside the scope of custody is an approach which was put forward by some industry players as more consistent with market practice.

Not providing any distinction would boil down to saying that assets provided as collateral are subject to record keeping. It would provide simplicity. However, this could lead to a situation where, for certain AIFs, all assets will be subject to record keeping.

[48] Definitions of financial collateral arrangements laid out in Directive 2002/47/EC ('the Collateral directive') which distinguishes two types of collateral arrangements:

(i) **title transfer financial collateral arrangements** defined as arrangements, including repurchase agreements, 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

(ii) **security financial collateral arrangements** defined as arrangements under which a collateral provider provides financial collateral by way of security to or in favour of a collateral taker, and where the full or qualified ownership of, or full entitlement to, the financial collateral remains with the collateral provider when the security right is established

Criteria to distinguish the different situations (temporary lending, repurchase arrangements, re-use, and collateral)

Box 79

Policy options	Benefits	Costs	Evidence needed
Option 1 Distinction on whether there is a transfer of ownership.	Clarity.	Transfer of ownership is not interpreted in the same way in all Member States.	
Option 2 Distinction on two criteria: - transfer of ownership - existence in the depositary's books	Custody duties only if control over the assets.		
Option 3 No distinction needed (by definition, assets provided as collateral are subject to record keeping)	Simplicity.	Lower investor protection. Oversight performed by the prime broker.	

A comparison of the costs and benefits of the different options does not rule out any of the three options. As a consequence ESMA would like to consult on all of them to get additional information from stakeholders.

b) Regime for temporary lending

ESMA suggested that where the financial instruments have been provided to a third party under a temporary lending agreement, they will no longer be held in custody by the depositary and fall under the definition of 'other assets' in accordance with Article 21 (8) (b).

12.3. Depositary functions pursuant – oversight duties

12.3.1. Objectives and underlying problems

In order to reduce micro-prudential risk and improve the investor protection, the depositary has to perform an oversight function. The AIFMD text lists five oversight duties inspired from the UCITS Directive.

To refine this oversight function, ESMA is requested to advise the Commission on the conditions the depositary must comply with in order to fulfil its duties pursuant to Article 21(9).

12.3.2. Options, impact and comparison

12.3.2.1. Specifying the depositary oversight duties

a) Form of the requirement

Oversight duties are very different across Member States and a clarification is needed to increase the level of harmonization as AIFs will be 'pass ported' across Europe and AIFMs will be granted a 'management company' passport by which they will be entitle to set up and to manage AIFs in other Member States. ESMA has to choose the proper form to present the elements specifying the depositary oversight duties. Four options were considered by ESMA: i) defining principles; ii) a

general principle based on a commonly shared assumption that the depositary performs ex post verifications; iii) a non-exhaustive list of tasks; and iv) an exhaustive list of tasks.

Defining **principles** to interpret each duty would provide a high level picture and a basis to start from. Nevertheless, adopting such a form, there is a risk that the objective of full harmonization would not be achieved.

A general principle starting from a **common assumption** that the depositary performs ex post checks and verifications of processes that are under the AIFM's responsibility would provide a higher degree of precision. A principle based approach provides a useful level of flexibility although the degree of harmonization will always remain a bit lower than with a list of requirements. Finally the cost of implementing the measures included in the precision has to be taken into account.

Establishing a **non-exhaustive list** of tasks the depositary should carry out to fulfil its oversight duties provides a high degree of harmonization although this harmonization is only minimum. It allows putting some key tasks in the list in order to ensure a minimum level of protection and efficiency. Nonetheless, with a non-exhaustive list, there is a risk that the objective of harmonization at market level is missed. Moreover, a list eliminates a lot of flexibility for the funds, creating a risk that the tasks included are very different from market practice for some of them. Implementation costs for the harmonized tasks have to be accounted for.

Establishing **an exhaustive lis**t provides the highest level of harmonization and clarity. Nevertheless, there is a high risk that new issues may not be detected by such a restrictive approach. The risk that the tasks listed do not correspond to the market practice of all types of funds is also important.

A comparison of the costs and benefits of the different options shows that a clarification of each duty on a principle based approach is the best way to ensure the right balance between flexibility and the objective of proper and comprehensive harmonization.

b) Content of the advice regarding oversight duties (Boxes 81 to 86)

In its advice, ESMA tried to provide precisions on the five oversight duties included in AIFMD and inspired from UCITS Directive. This initiative was motivated by the need for harmonization of regulation in the different members States. Moreover, as the question is highly related to the requirements set by the UCITS directive on the same topic, ESMA has tried to come up with a more updated approach concerning the depositary's oversight duties. This is motivated by the fact that the provisions regarding the depositary's oversight duties in the UCITS Directive were defined in 1985 and have not been modified since.

Although ESMA is aware that a special focus should be put on the duties (b) and (c), its opinion is that some improvements and clarification can be provided for all of the five oversight duties.

ESMA particularly strived to take into account the proportionality principle on this topic. Indeed, it seems sensible to have specific requirements where it provides a higher level of security and where it is possible. Regarding oversight duties, although ESMA suggests requiring as a general principle ex-post monitoring, it is relevant to let the depositary perform ex ante verifications when it deems it appropriate. The input from the industry will be particularly relevant on this issue to determine which degree of differentiation is workable and how differentiation can apply to non-bank depositaries.

c) Anti-avoidance rule

For AIFs investing in assets through a vehicle set up for this purpose (holding company, SPV, SIV, underlying funds of FoFs, etc.) the depositary should be satisfied that the setting up of the vehicle in between the AIF and the target assets is not intended to circumvent rules applicable to depositaries. When the said vehicle has itself a depositary, this condition is met (exclusion of FoFs when underlining funds are UCITS or AIFs managed by an EU AIFM).

12.4. Due diligence duties

12.4.1. Objectives and underlying problems

In order to reduce micro-prudential risk and improve investor protection, the AIFMD text states that the depositary is prohibited from delegating to a third party any of its functions except those referred to in paragraph 8. It allows the depositary to delegate to third parties the functions referred to in paragraph 8 only if some conditions are respected. Among these conditions, there is a requirement for the depositary to exercise all due skill care and diligence in the selection, appointment and periodic review of the concerned third party. To clarify this duty, ESMA is:

i. requested to advise the Commission on the duties the depositary has to carry out in order to fulfil its duties pursuant to Article 21(11).

ii. encouraged to develop a comprehensive template of evaluation, selection, review and monitoring criteria to be considered by the depositary while exercising its due diligence duties under Article 21(10).

More precisely, ESMA is asked to develop options in terms of content of due diligence activities and discuss potential impacts on costs and risks to investor protection in a qualitative form.

While elaborating its advice, ESMA has considered that the depositary's liability regime provides a strong incentive for the depositary to perform a very detailed level of due diligence towards its sub-custodian network. Accordingly, ESMA expects the depositary to go beyond any requirements set out in its advice.

12.4.2. Options, impact and comparison

12.4.2.1. Determining due diligence duties for the depositary

a) Form of the requirement dealing with the procedure for the selection and the periodic review (Box 77)

ESMA has to put forward which approach to take to provide requirements to the depositary when it appoints a third party to perform safekeeping duties, a sub-custodian in most cases. ESMA considered four options: i) a simple principle based approach; ii) a principle based approach including conditions applicable to the sub-custodian; iii) a non-exhaustive list of tasks; and iv) an exhaustive list of tasks.

Providing principles allows for more flexibility for depositaries when appointing sub-custodians. A principle based approach provides stronger investor protection since to the responsibility lies with the depositary and in case the procedures for due diligences have not been applied in line with principles established in legislation, the liability of the depositary still remains. However, such an option contains a certain level of legal uncertainty which could cause a rise in the compliance costs and divergence in implementation

Complementing the principle based approach by **specifying the conditions applicable to the sub-custodian** provide additional diligences and, as a consequence, a higher level of investor protection. Nevertheless, a certain level of legal uncertainty remains. The rise of compliance cost would also be maintained.

Establishing a **non-exhaustive list** of diligences leads to a minimum standard of diligences which is also foreseeable by the depositaries. Therefore the level of legal uncertainty is reduced and the related compliance costs are lowered. Nonetheless, such a list cannot cover all possible situations of appointment of a sub-custodian so it does not provide the best level of investor protection.

Establishing an **exhaustive list** of acts that the depositary has to perform at the time of the appointment would provide a high degree of harmonization throughout the European Union. It also highly reduces legal uncertainty and compliance costs by limiting diligences to a box ticking process. Nevertheless, ticking boxes does not provide a very safe framework for the appointment of a sub-custodian.

An assessment of the costs and benefits of the different options underlines that a principle based approach including criteria to be met by the sub-custodian is the most suitable form to provide requirements to the depositary when selecting a sub-custodian.

b) Criteria for the due diligence duties

ESMA suggested some criteria the depositary has to fulfil when performing its due diligence duties. These criteria cover both the selection and the on-going monitoring of the different entities of its sub-custodian network. Again, ESMA is aware that the depositary is likely to go far beyond the requirements it suggests because of the liability it is subject to. However, it would remain useful to require the depositary to have a documented

process for the due diligence so to facilitate the assessment by the competent authorities. In the same perspective, designing a contingency plan appears as a best market practice that should be generalized. It is a way for the depositary to deepen its knowledge of the markets where its sub-custodian operates. It also allows the depositary to react much quicker to any trouble in the market. Finally, the requirement to terminate the contract when the delegate does not comply with the standards imposed by the depositary anymore increases investor protection.

12.4.2.2. Establishing a comprehensive template

ESMA was encouraged to provide a comprehensive template for the due diligence duties.

Establishing a comprehensive template would provide a more harmonized supervisory approach. It would provide clarity and reduce the uncertainties in understanding rules, thus lowering the risk of non-compliant behaviours or models. However, such an option would imply a very high degree of rigidity and it is very unlikely that a single comprehensive template can be relevant for the large number of different business models and legal environments.

Not providing a comprehensive template would provide the level of flexibility require to adapt to a large range of different business models and legal environments. The risk of having a lower degree of harmonization would be mitigated, to a large extent, by the provision of a range of minimum due diligence duties. Once again, the liability regime imposed by the AIFMD to the depositary ensures that the latter will perform a very strong level of due diligences on its sub-custodian network.

Designing a comprehensive template

Policy options	Benefits	Costs	Evidence needed
Option 1 Establishing a model agreement	Higher degree of harmonization.	High degree of rigidity and impossibility to be relevant for all types of AIF.	
Option 2 Not providing a model agreement	Preservation of the adaptability to a wide range of business models and legal environments.		

A comparison of the costs and benefits of the different options underlines that it is preferable not to establish a comprehensive template for the due diligences. However, some detailed criteria that the depositary would be required to ensure can be a more relevant answer to the request. These criteria can be inspired from current best market practices.

12.5. The segregation obligation

12.5.1. Objectives and underlying problems

In order to reduce micro-prudential risk and improve investor protection, segregation must not only be performed at the depositary's level but at the level of any sub-delegates well. Thus, in addition to the due diligence requirement mentioned in the previous part, the depositary has to ensure that the segregation is achieved at any of its sub-delegates. Complying with this requirement is one of the conditions to be met for delegation to a third party of duties referred to in paragraph 8. To clarify this obligation, ESMA is requested

i. to advise the Commission on criteria to be satisfied to comply with the segregation obligation whereby the depositary shall ensure on an on-going basis that the third party fulfils the conditions referred to in Article 21(11)(d)(iv).

More precisely, ESMA has to discuss potential impacts of different options for segregating assets in sub-custody pursuant paragraph 11(d)(iv) on costs and risks to investor protection.

12.5.2. Options, impact and comparison

12.5.2.1. Determining the criteria to comply with the segregation obligation (Box 88)

The request clearly specifies that ESMA has to refer to Article 16 of Directive 2006/73/EC (MiFID) in its advice on this issue. ESMA considered whether adapting the requirements set out in that Directive to be tailored to AIF specificities.

A**rticle 16 of Directive 2006/73/EC** (MiFID) provides a strong basis to design the segregation requirements imposed by the AIFMD . Inspiring from it would ensure consistency of regulations concerning similar sectors and purposes. Adapting the requirements to AIF specificities is very unlikely to threaten these benefits or create additional costs. Meanwhile, a tailored approach is more likely to be sensible. This option would leave some flexibility to the depositary to decide which way is the most relevant to ensure that its sub-delegates comply with the segregation obligation. The depositary can thus adapt its oversight of the segregation according to, for instance, the type of risk, the national law or the types of assets entrusted to any of its sub delegates.

These practical procedures may include asking the national authority of the sub-custodian to send a certificate, requiring that the depositary verifies itself that the assets are held by the sub-custodian in a pooled omnibus account or even requiring that a legal opinion is made in order to verify that the segregation requirement is applied in the sub-custodian's jurisdiction.

12.6. Loss of financial instruments

12.6.1. Objectives and underlying problems

An important objective is to set strict rules to ensure a high level of investor protection while at the same time not putting the entire responsibility on the depositary as this would counterproductively increase the incentive for regulatory arbitrage or not imposing rules that may lead in some circumstances to systemic risk. To do so, the AIFMD text states that the depositary is liable to the AIF for the loss by itself or a third party to whom the custody has been delegated. In such a case, the depositary is obliged to return financial instruments of identical type or the corresponding amount. However, there is no liability if the loss results from an external event beyond the depositary's reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary. To provide more clarity to this liability regime, ESMA is requested:

i. to advise the Commission on the conditions and circumstances under which financial instruments held in custody pursuant paragraph 8(a) shall be considered as 'lost' according to Article 21(12)

ii. to specify circumstances when such financial instrument should be considered permanently 'lost' , to be distinguished from circumstances when such financial instruments should be considered temporarily 'unavailable'

To that end, ESMA shall consider inter alia the following circumstances:

- Insolvency of, and other administrative proceedings against, a sub-custodian;
- Legal or political changes in the country where financial instruments are held in subcustody;
- Actions of authorities imposing restrictions on securities markets;
- Risks involved through the use of settlement systems; and
- Any other circumstances which may prevent the AIF from using or disposing of its assets that are kept in custody by a depositary or a sub-custodian.

12.6.2. Options, impact and comparison

12.6.2.1. Definition of the 'loss of financial instruments'

a) <u>Form of the definition (Box 89)</u>

ESMA has to put forward which format to use to provide a definition of the 'loss of financial instruments'. Four options were considered by ESMA: i) an exhaustive list of cases; ii) a non-exhaustive list of cases; iii) a list of criteria; and iv) the definition of a procedure.

Establishing an **exhaustive list** of cases in which financial instruments should be considered as 'lost' would only provide guidance to the courts and the applicable parties. It may create extra costs regarding the extra information required in legal opinions. The industry, in general, is opposed to such an option.

Establishing a **non-exhaustive list** rather than an exhaustive list would not change any thing to the costs and benefits involved. It would even lead to more uncertainty.

Having **criteria** on which it will be possible to establish whether the assets are lost would be more workable than having restrictive definitions. Indeed, criteria are easier to implement in all jurisdictions. However, this option may create extra costs regarding the extra information required in legal opinions. Therefore, these criteria have to be detailed enough to bring certainty and to cover possibly all types of situation in which assets belonging to an AIF could be lost while under custody.

A **procedure** to decide whether there is a loss will fit in all legal systems because it would not deal with non-harmonised issues. With a procedure already set, the transparency and investor's information is enhanced. However, such a degree of information implies some implementation costs for markets parties and investors since they would support the expenses of settling the procedures.

It seems that the different options are not exclusive and can rather complement each other. Thus, ESMA decided to provide an advice in the form of some criteria to declare if an asset is lost. Meanwhile, it comes up with a non-exhaustive list of some situations where the financial instruments held in custody can be deemed lost. This list includes, inter alia, fraud and insolvency of a sub-custodian.

b) Process to declare the loss (Box 89)

ESMA has considered the possibility to suggest which process to be followed to declare the financial instruments 'lost'. ESMA considered three options: i) a mediation procedure; ii) an escalation process; and iii) not providing any additional requirement

A **mediation procedure** predefined upon the appointment of the depositary would make it possible to avoid the expenses of a trial when an agreement is reachable. However, such an agreement is likely to be found only for a limited number of situations, when the amounts at stake are low for example.

An **escalation process** would provide independence and expertise to the process by referring to an independent party, an auditor for example. However, it creates an additional cost corresponding to the remuneration of the auditor. It is even possible that this additional cost does not bring any added value if, in the end, it is the court which has to decide. Moreover, even if the auditor is independent, the market structure may entail a strong risk of conflict of interest.

It has to be noted that a mediation procedure and an escalation process are very similar options which can be designated by the expression 'conciliation process'. In this process, the auditor would be one among many different external actors who can potentially be appointed for the mediation.

Not **providing additional requirement** to the contract because of the assumption that any material disagreement will be settled by the relevant courts would provide more flexibility. In general, the industry supports the idea that it should be up to the courts to decide whether an asset is lost when the amount at stake is material. However, the harmonization objective would not be achieved since the room for interpretation left to the different national courts is important.

Process to declare the loss

Policy options	Benefits	Costs	Evidence needed
Option 1 Mediation procedure	Possibility to avoid the expenses of a trial when an agreement is reachable	Limited number of potential cases concerned	
Option 2 Escalation process	Independence Expertise	Cost of appointing an auditor Risk of conflict of interest	
Option 3 Not providing any additional requirement	More flexibility	Risk of not achieving the harmonization objective	

A comparison of the costs and benefits of the different options suggests that not providing additional requirement would provide a suitable degree of flexibility while leaving the door open to a conciliation procedure when deemed appropriate by the parties involved.

12.6.2.2. Distinction between permanently 'lost' and temporarily 'unavailable' (Box 89)

ESMA has to put forward how to distinguish situations where the assets are 'permanently lost' from situations where they are only 'temporarily unavailable'. ESMA considered three options: i) setting a maximum time period; ii) relying on the notion of durability; and iii) relying on the notion of permanence.

Setting a maximum period of time after which the assets would be considered as 'permanently lost' and no more 'temporarily unavailable' would provide clarity and would ensure a high level of harmonization. Nonetheless, it is very unlikely that a single time period is relevant for all types of assets and, more generally for all kinds of situations. Moreover, there is a risk of discrepancy between the status of the assets and the reality when assets are unavailable for a period longer than the maximum time period authorized. There was a broad consensus within ESMA that such an option would be unworkable.

Relying on the notion of durability would include a large number of cases where assets are unavailable on such a long period that they can be deemed lost. It would improve investor protection by ensuring that the AIF can recuperate its assets in a shorter period of time. However, the notion of durable is not defined precisely enough to provide a sufficient level of legal certainty. It leaves too much room for interpretation and would prevent from a maximum harmonization.

Relying on the notion of permanence would provide a much higher level of clarity. On this issue, it seems important to have as much simplicity as possible to provide a harmonized framework. Nonetheless, this option is quite restrictive and it would limit the number of cases where assets are considered as lost.

Distinction between 'permanently lost' and 'temporarily unavailable'

Policy options	Benefits	Costs	Evidence needed
Option 1 Maximum time period	Clarity High level of harmonization.	Risk of discrepancy between the asset status and reality. One size cannot fit all situations.	
Option 2 Relying on the notion of durability	Increase in investor's protection.	Low degree of precision. Room for interpretation.	
Option 3 Relying on the notion of permanence	Higher level of clarity.	Restrictive approach.	

A comparison of the costs and benefits of the different options suggests that is more appropriate to rely on the notion of permanence to distinguish between 'permanently lost' and 'temporarily unavailable'. In its advice, ESMA associates the notion of permanence to some criteria defining a situation where assets are considered as lost.

12.7. External events beyond reasonable control

12.7.1. Objectives and underlying problems

In the same perspective as the precedent part, the AIFMD text states that the depositary is not liable if the loss results from an external event beyond the depositary's reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary. To clarify this point, ESMA is requested:

i. to advise the Commission on conditions and circumstances for events to be considered as:
   - external,
   - going beyond reasonable control, and
   - having consequences which would have been unavoidable despite all reasonable efforts to the contrary.

ii. if possible, to advise the Commission on a non-exhaustive list of events where the loss of assets can be considered to be a result of an external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary

12.7.2. Options, impact and comparison

12.7.2.1. Definition of 'external event beyond the depositary's reasonable control, the consequences of which were unavoidable despite all reasonable efforts to the contrary' (Box 91)

ESMA has to define under what conditions and circumstances, an event should be considered as (i) external, (ii) beyond its reasonable control, (iii) the consequences of which were unavoidable despite all reasonable efforts to the contrary.

In line with the European Commission's request, in its advice, ESMA suggests criteria for each condition to help the parties assess whether the depositary should be held liable. Those criteria will have to be judged in light of the specific event which led to the loss. Further, all conditions must be met for the depositary not to be required to return financial instruments or the corresponding amount.

ESMA has carefully considered whether to provide a list of events but quickly decided it would not be possible to identify all possible situations and rather decided to consult the industry on the types of events which could lead to a loss. Nevertheless, it has included in its advice some practical examples to describe how the criteria set out should apply. ESMA has particularly addressed the case of insolvency of a sub-custodian which represents the greatest concern in the industry.

First, ESMA has suggested in the definition of a 'loss' to consider that if a sub-custodian files for bankruptcy, the financial instruments it held in custody should not be considered 'lost' until the end of the insolvency proceedings. Here ESMA further recommends considering that if the depositary can prove that the assets were appropriately segregated by the sub-custodian but that there are assets missing at the end of the liquidation

procedure because sub-custodian the national insolvency law does not recognize the segregation principle, then the event which caused the loss should be considered as an 'external event beyond the reasonable control of the depositary'.

Finally, while developing the conditions to be complied with by the depositary to be exonerated from its liability in case of loss of financial instruments, ESMA has tried to assess from a cost / benefit perspective the implications of the criteria set out. ESMA has identified the following potential economic repercussions which could stem from the implementing measures regarding the depositary's liability, depending on the criteria retained for the definition of the 'external event beyond reasonable control'. First, some consider that the framework designed could increase systemic risk by concentrating the custody function among a small number of systemically important entities. The industry further stresses that this type of loss is unlikely to be insurable and would probably have prudential consequences for the depositary and give rise to additional capital requirements. It is also likely that the associated costs would be passed on to AIFs and the European Union attractiveness vis-à-vis alternative investment funds would be threatened. Besides, some small or medium European depositaries underline that this regime is very favourable to the large depositaries which are present in many countries. It can deter smaller depositaries to enter other markets and may lead to a concentration of the activity within a small number of global custodians, many of which are non-European. Finally, such a regime could create moral hazard for the AIF. Knowing that the depositary would be liable in most instances, the AIF has an incentive to maintain its investment in a market which has become very risky despite receiving a large number of alerts from its depositary.

Thus, among the evidence needed from the industry are the capital charges required by the depositary to face this responsibility. Some industry members consider that, under the darkest scenario, the depositary would be liable to return the financial instruments entrusted to a sub-custodian. One industry player estimates that its capital charges would increase from 1.5 basis points of total assets under custody to 160 basis points which could be higher than total management fees. Extended to all European depositaries, the increase in capital charges for non UCITS funds could amount to €32 billion, a figure which would have to be confirmed by prudential authorities.

Liability regime for the depositary

Policy options	Benefits	Costs	Evidence needed
Option 1 Definition of external event beyond reasonable control, the consequences of which were unavoidable despite all reasonable efforts to the contrary	High degree of investor protection. Insurance of a strong level of due diligence.	High capital cost for the depositaries. Increase in systemic risk. Moral hazard.	Capital charges required for the depositary to cope with its responsibility. Estimated increase in costs.

A comparison of the costs and benefits underlines that input on this question from stakeholders would be highly valuable. In addition, ESMA envisages entering into a targeted dialogue with its prudential counterparts to assess the implications of the advice in terms of prudential supervision of depositaries.

12.7.2.2. Non-exhaustive list of events

ESMA has to recommend whether or not providing a non-exhaustive list of events deemed as '*external event beyond the depositary's reasonable control, the consequences of which were unavoidable despite all reasonable effort to the contrary*'.

A non-exhaustive list provides some indication which can contribute to more legal certainty. Some situations would clearly fall under the elements of the list and no further discussion would be needed. Moreover, given that it is only non-exhaustive, it does not create a risk of becoming obsolete.

As a consequence, ESMA decided to provide a short list of situations considered as '*external event beyond the depositary's reasonable control, the consequences of which were unavoidable despite all reasonable effort to the contrary*'. It strongly stresses that this list is non-exhaustive and has to be taken as a complement to the definition of 'an external event beyond reasonable control'.

12.8. Objective reason to contract a discharge of responsibility

12.8.1. Objectives and underlying problems

In the same perspective as the two preceding parts, the AIFMD text states that, under certain conditions, the depositary has the possibility to discharge its liability in the event of loss of financial instruments held in custody by a third party. It is specified that such conditions must be clearly stated in a written contract between the depositary and the AIF to establish an objective reason to contract a discharge. To better understand the issues of contracting a discharge, ESMA

i. is requested to advise the Commission on the conditions and circumstances under which there is an objective reason for the depositary to contract a discharge pursuant to Article 21(13).

ii. is encouraged to provide an indicative list of scenarios that are to be considered as being objective reasons for the contractual discharge referred to in Article 21 (13).

12.8.2. Options, impact and comparison

12.8.2.1. Objective reason to contract a discharge (Box 92)

ESMA has been requested to provide an advice on the conditions and circumstances under which there is an objective reason for the depositary to contract a discharge pursuant to Article 21(13). To do so, ESMA has considered whether the situations where there is an objective reason to contract a discharge should be restricted. ESMA strongly believes the possibility for the depositary to transfer its liability if some conditions are fulfilled should be maintained. In this perspective, it is also fully aware that having too restricted conditions for the objective reason to contract a discharge would prevent the depositary from doing so.

Restricting the conditions under which there is an objective reason to contract a discharge would follow some criteria, e.g. legal and economic constraints. In this perspective, the depositary can contract a discharge if it has no other option but to delegate its custody duties to a third party or it was in the best interest of the investors or when there was an agreement that the benefits of the discharge outweigh the costs. This option would take into account many situations where the depositary has no other option but to delegate its custody duties to a third party. It would also foster investor protection not only by taking its best interest into account but by requiring the responsible party to repay the loss where a transfer of liability has taken place. However, by restricting the possibility for the depositary to transfer its liability, this option entails a risk of preventing the depositary to do so in practice. Moreover, it may lead to a concentration of the liability on a limited number of institutions, thus increasing systemic risk.

A second option would consider that the AIFMD text already provides a level of safeguards protective enough. Accordingly there would be an objective reason to contract a discharge when the AIFM and the depositary have explicitly agreed through a written contract that the depositary can discharge its responsibility. Such conditions would provide more flexibility for the depositary. The freedom of contract would not be affected thus market efficiency would be fostered. Nonetheless, the degree of investor's protection would not be improved as the investor's best interest would not be taken into account.

Objective reason to contract a discharge

Policy options	Benefits	Costs	Evidence needed
Option 1 Written agreement dealing with legal constraints and weighting of associated costs / risks	Investor's best interest taken into account.	Increase in systemic risk. Restrictive approach.	
Option 2 Establishing criteria based on Article 16 of Directive 2006/73/EC No further requirement (Contractual agreement establishes an objective reason)	Flexibility. Freedom of contract not affected.	No additional level of investor protection. Investor's best interest not taken into account.	

A comparison of the costs and benefits of the two options does not allow one to roughly rule out one option. Thus, it seems reasonable to consult on both of them.

12.8.2.2. Indicative list of scenarios

ESMA had to consider whether or not providing an indicative list of situations under which there is an objective reason for the depositary to contract a discharge pursuant to Article 21(13). Such a list would provide clarity and limit the room for potential divergent interpretation. However, there is a very high risk of missing a large number of cases, thus creating loopholes. The market practice is very likely to evolve with time so there is a high chance that what is considered as objective reason to contract a discharge today might not be the same tomorrow.

The strong probability for a list to be quickly obsolete deterred ESMA from establishing an indicative list of scenarios. However, in the explanatory text, ESMA included some examples of situations where there is an objective reason to contract a discharge (e.g. investment in a fund in a country where the depositary is not present, etc.)

13. Leverage

13.1. Leverage Definitions

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

Risks addressed / Policy objective

- Harmonised regime of calculation of leverage
- Macro-prudential risks
- Micro-prudential risks
- Investor protection

Scope Issues

Hedge funds, Venture capital, Private equity and Real estate;

13.2. Box 93: Leverage calculation

Definitions - specifying how leverage shall be calculated

Risks addressed / Policy objective

- Harmonised regime of calculation of leverage
- Macro-prudential risks
- Micro-prudential risks
- Investor protection

Scope Issues

Hedge funds, Venture capital, Private equity and Real estate;

Option	Benefits	Costs	Evidence
Option 1 Setting out one method for the calculation of Leverage	**Harmonisation**: Would provide a highly harmonised approach to the calculation across the EU and result in easy aggregation by ESMA	**Investor Protection**: One method may not be universally applicable to all type of AIF such that the resulting calculation of leverage provides investors with a misleading view. **Administrative Burden**: One method may be costly to apply and result in a misleading view of the overall exposure of the AIF i.e. option based strategies. **Macro-prudential risks**: If all AIFM are managing leverage using the same method then an external sock could cause pro-cyclical effects if all AIFM acted in the same way.	Targeted industry engagement and consultation.

Option 2 Setting out more than one method for the calculation of leverage	**Micro-prudential risks**: Provides flexibility for AIFM to tailor the calculation for specific types of AIF and specific investor interpretations of 'leverage' **General**: reduces the costs associated with option 1.	**Harmonisation**: Reduced harmonisation of applicable, however if one of the methods is highly harmonised then this cost is reduced. **Administrative Burden**: AIFM may need to calculate more than one figure and this may result in initial costs to set up the technological infrastructure. However this may facilitate the monitoring of systemic risk by competent authorities.	Targeted industry engagement and consultation.

Option 3 Permitting the netting of positions in line with the Commitment Approach in the CESR Guidelines	**Micro-prudential risks:** Robust standards provided by CESR Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for Ucits. **Micro-prudential risks:** Appropriateness of the method for a large majority of AIF (according to IOSCO's survey) **Administrative Burden**: No additional burden for AIFM already managing Ucits funds	**Investor protection**: Potential to under estimate the exposure of AIF. In certain cases, this indicator does not provide meaningful information to regulators. However more useful information to investors. **Macro-prudential risks** Permitting netting and hedging arrangements could limit insight of authorities to systemic risk. However when combined with other methods may provide a useful benchmark. **Micro-prudential risks**: Inappropriateness of the method for certain AIF (e.g. in case of complex investment strategies, use of exotic derivatives and options)	Targeted industry engagement and consultation.

Option 4 Permitting a more flexible approach to the netting of positions and the general calculation of exposure	**Micro-prudential risks** For complex strategies/derivative instruments this method ensures the possibility to consider the different risk levels of diverse instruments and strategies, including hedging and correlation effects (i.e. option hedging). **Administrative Burden**: Specific tailoring for the heterogeneous population of AIF.	**Macro-prudential risks:** This method provides a wide degree of flexibility to AIFM in the calculation of the exposure of the AIF. The flexibility reduces the degree of comparability between AIF: therefore, it cannot be applied on a stand-alone basis. **Harmonisation**: Reduced harmonisation of applicable, however if one of the methods is highly harmonised then this cost is reduced.	Targeted industry engagement and consultation.

13.3. Box 100: Limits to Leverage - the principles specifying the circumstances in which competent authorities shall exercise the powers granted pursuant to Article 25(3) and the timing of such measures.

Risks addressed / Policy objective

- Pro-cyclical herding behaviour
- Effect of deleveraging on asset prices
- Spill over effects

Scope Issues

General issues of proportionality.

Option	Benefits	Costs	Evidence
The setting out of illustrative circumstances and criteria that should guide the assessment taken by competent authorities	It would not be possible to set out a full list of factors that competent authorises should consider prior to exercising their right to impose leverage limits and as such the list provided is illustrative and it is hoped will result authorities adopting detailed investigations prior to taking action.	The approach taken does not lend itself to a high degree of harmonisation as different interpretations may arise and therefore different actions may be taken on the basis of similar circumstances.	Consultation

The setting out of timelines for the imposition of limits	None	It is not appropriate to set any strict or pre-determined timeframes or rules identifying or pinpointing the precise timing of any supervisory intervention by competent authorities in relation to the use of leverage by AIFM. Any such timeframes or rules could fetter the regulatory judgment of competent authorities, and potentially risk reducing the effectiveness or proportionality of any appropriate supervisory measures to be imposed on AIFM. ESMA considers that the question of appropriate timing for the imposition of measures should be a matter for the judgment of competent authorities in each case. It also believes that the competent authority's judgment on appropriate timing should be determined with reference to avoiding or minimising any potential manifestation of systemic risk, with the principal objective of maintaining the stability and integrity of the financial system.	Consultation

14. Transparency

14.1. Boxes 104 and 105: Content and format of balance sheet, income of expenditure and report on activities for the financial year.

Annual report - specifying the content and format of the annual report. These measures shall be adapted to the type of AIF to which they apply.

Risks addressed / Policy objective

- Asymmetric information

- Investor Protection
- Market Integration

Scope Issues

Annual report provisions will apply to all AIFM but need to consider requirements of local and international GAAPs to ensure AIF will be able to remain compliant.

Option	Benefits	Costs	Evidence
Overview/summary: Annual Report	Mitigate information asymmetry, increase market efficiency through a common approach to protecting investors in AIFM managed funds.	May require one off costs to change format of financial statements including re classification of comparatives where presented and incremental compliance costs for AIFM (additional disclosure, calculation, preparation and audit costs).	Level of one off costs to change format of financial statements and incremental compliance costs for AIFM (additional disclosure, calculation, preparation and audit costs). Feedback on the concerns of the industry with regard to possible incompatibility with local GAAP or rules of the AIF.
Option	**Benefits**	**Costs**	**Evidence**
		If measures are too prescriptive or specific may lead to non-compliance with local GAAP resulting in qualified audit opinions or the provision of additional versions of the financial statements resulting in increased costs.	

Option 1 **Option presented in Consultation Paper in relation to Annual report:** Provision of minimum requirements (specifying key elements of financial statements and provision of a non-exhaustive list of underlying line items recognising the concept of materiality and the need to tailor to type of AIF) with the application of relevant accounting standards and rules.	Mitigate information asymmetry, increase market efficiency through a common approach to protecting investors in AIFM managed funds; Requirements should be capable of calibration in an appropriate, differentiated and proportionate manner, which duly reflects the specific characteristics including legal structure, applicable EU and national legislation and adopted accounting standards or rules of the AIF.	May require one off costs to change format of financial statements including re classification of comparatives where presented and incremental compliance costs for AIFM (additional disclosure, calculation, preparation and audit costs).	Level of one off costs to change format of financial statements and incremental compliance costs for AIFM (additional disclosure, calculation, preparation and audit costs). Feedback on the concerns of the industry with regard to possible incompatibility with local GAAP or rules of the fund

Option 2 **Option rejected by ESMA:** Specification of minimum content with the application of relevant accounting standards and rules.	Mitigate information asymmetry, increase market efficiency through a common approach to protecting investors in AIFM-managed funds;	May require one off costs to change format of financial statements including re classification of comparatives where presented and incremental compliance costs for AIFM (additional disclosure, calculation, preparation and audit costs). If measures are too prescriptive or specific may lead to non-compliance with local GAAP resulting in qualified audit opinions or the provision of additional versions of the financial statements resulting in increased costs	Level of one off costs to change format of financial statements and incremental compliance costs for AIFM (additional disclosure, calculation, preparation and audit costs). Feedback on the concerns of the industry with regard to possible incompatibility with local GAAP or rules of the fund

14.2. Box 106: Disclosure requirements in relation to remuneration

The annual report shall contain disclosures in relation to the following: Article 22(2)(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; Article 22(2)(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**.**

Risks addressed / Policy objective

- Asymmetric information
- Investor Protections
- Market Integration

Scope Issues

All AIFM for each EU AIF it manages and for each of the AIF it markets in the EU.

Option	Benefits	Costs	Evidence
Option 1: **Option presented in Consultation Paper in relation to the content and format of remuneration disclosure:** Provision of flexibility as to whether total remuneration is disclosed at the level of the AIFM or the level of the AIF subject to the requirement to provide further perspective where information is provided at the level of the AIFM.	Enables investors to assess how remuneration paid relates to overall fund performance and how it supports effective risk management; Enables comparison across funds and assessment of risk; Benefits will depend on whether information is used and understood, on the quality of information provided and its comparability.	Set up (extraction of information in relation to the AIF or in relation to employees involved in the activities where presented at the level of the AIFM) and ongoing incremental compliance costs for firms (recalculation, in-creased preparation costs due to increased level of disclosure and increased audit costs); Potential additional costs in relation to: ▪ Changes in systems and controls ▪ Changes in data collection and reporting ▪ Record keeping Could result in an unlevel playing field for small funds due to inability to disclose information at aggregate level if this not taken in to consideration in the advice proposed. Could result in breach of confidentiality or disclosure of proprietary information.	Feedback from the industry on the ability to extract this information in an efficient and effective manner. Feedback from the industry on possible issues in relation to small AIFM's who have limited employees and where aggregate disclosure split by senior management and risk takers allows the identification of the remuneration for individual members of staff.

14.3. Disclosure obligations to investors

Disclosure to investors - specifying the disclosure obligations of AIFM referred to in paragraphs 4 and 5. These measures shall be adapted to the type of AIFM to which they apply. (No 37 in the mandate, Art. 23).

Risks addressed / Policy objective

- *Macro-prudential (systemic risks), the use of leverage*: The absence of a consistent approach to the collection of macro-prudential data (on leverage, risk concentrations etc.) and of effective mechanisms for 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.

- *Investor Protection*: Although the majority of investors in AIF are professional and qualified, the financial crisis has demonstrated that even this category of investors requires reliable and comprehensive information from AIFM on an initial and ongoing basis. National regulatory approaches to disclose practice and governance vary and do not appear to provide a consistent regulatory underpinning for AIFM practice in this area.

- *Market Integration*: If disclosure obligations are harmonised among Member States, investors can better compare information provided which will contribute to the development of a single market for AIF.

- *Acquisition of control of companies by AIFM*: Concerns in relation to the impact of private equity activity on their portfolio companies relate to: (1) the sustainability of the debt taken on by the portfolio company in a leveraged buy-out transaction and (2) the rights of employees throughout the buy-out transaction in particular. Empirical evidence on these points is not conclusive. There are national and European regulatory provisions providing general safeguards to accommodate these concerns. However, greater transparency and public accountability of private equity activities would help to ensure that the interests of all relevant stakeholders are taken into account in the governance of portfolio companies.

Scope Issues

Disclosure provisions will apply to all AIFM but need to be scalable.

Option	Benefits	Costs	Evidence

Overview/Summary: **Disclosure to investors**	Identify players of systemic relevance through the disclosure of risks incurred, their management, leverage levels and changes in liquidity management and ensure a proper macro-prudential monitoring of AIFMs and the AIFs they manage. Mitigate information asymmetry, increase market efficiency through a common approach to protecting investors in AIFM-managed funds; Greater public accountability of private equity transaction (debt levels incurred). Ensuring a level playing field for AIFMs in the single market and developing a single market in AIF with minimum common disclosure standards; Reduce potential for weakness in investor disclosures as barrier to effective due diligence;	Set up and incremental compliance costs for AIFM (recalculation, publication costs). Possible calibration failures of proportionality concerns and resulting competitive issues for certain players.	Set up and incremental compliance costs for AIFM (recalculation, publication costs). Feedback on the concerns of the industry with regard to the calibration of measures.

14.4. Box 107: Disclosure of the percentage of the AIF's assets which are subject to special arrangements arising from their illiquid nature.

Risks addressed / Policy objective

- Investor Protection
- Macro-prudential risks

Scope Issues

All AIFM for each EU AIF it manages and for each of the AIF it markets in the EU

Option	Benefits	Costs	Evidence
Overview/summary	Enables regulators to get a view on the build-up of illiquidity issues in the market; Warning signs to investors in AIF concerned who may make alternative arrangements when they need liquidity;	Set up (calculation for percentage of assets subject to special arrangements method for leverage) and incremental compliance costs for firms (recalculation, publication costs)	Feedback from the industry on the added value of timely disclosures with regard to liquidity issues. Input on the most appropriate timeline for this information

Option 1 **Option presented in Consultation Paper in relation to disclosure of percentage of assets subject to special arrangements[49]:** Disclosure frequency to align with the AIF's periodic reporting to investors. Disclosure content to include an overview of the special arrangements including valuation methodology applied and the impact on management and performance fees in relation to these assets.	Limits risk of contagion of liquidity issues as underlying investors can take measures to manage their liquidity; Reduces investor frustration and reputational risk for the AIFM through clear communication;	Low incremental costs as disclosures are part of periodic reporting costs (set-up and maintenance) at the regulators for receiving and processing the information;	Cost of compilation and disclosure of information in periodic reporting. Input on the definition of 'special arrangements'.

14.5. Box 107: Disclosure of any new arrangements for managing the liquidity of the AIF.

Risks addressed / Policy objective

- Investor Protection
- Market Integration
- Macro-prudential risks

Scope Issues

All AIFM for each EU AIF it manages and for each of the AIF it markets in the EU

[49] Special arrangements has been defined as an arrangement that arises as a direct consequence of the illiquid nature of the assets of an AIF which impact the specific redemption rights of investors in a class of units or shares of the AIF and which is a bespoke or separate arrangement from the general redemption rights of investors.

Option	Benefits	Costs	Evidence
Overview/summary	Proper monitoring of macro-prudential risks through enhanced transparency of AIFM activity; Common approach to protect professional investors in AIFM managed funds;	Cost of compilation and disclosure of information on an ad hoc basis. Investors and new creditors may shun AIFs and AIFMs with disclosed liquidity issues thereby further exacerbating liquidity problems;	Cost of compilation and disclosure of information on an ad hoc basis.
Option 1 **Option presented in Consultation Paper in relation to disclosure of new arrangements for managing liquidity:** Disclosure triggered by a material change to the liquidity management systems and procedures Immediate notification required where AIFMs activate gates, side pockets or similar special arrangements or in the event of a decision to suspend redemptions Disclosure to contain an overview of the changes to the arrangement including where relevant the terms under which redemption is permitted and the circumstances defining when management discretion is enabled.	Common approach for all AIFM mitigates information uncertainty and information asymmetry for investors.	Incremental costs for AIFM at every material change in liquidity management systems; Costs for regulators for receiving and processing information; Disclosure requirements may give investors a false sense of security (some issues may still not be disclosed especially where management discretion is enabled).	Evidence of instances that are considered material changes by the industry under the current definition and resulting disclosure costs; Evidence of liquidity Arrangements that would likely be taken by the industry;

14.6. Box 107: Disclosure of the current risk profile of the AIF and the risk management systems employed by the AIFM to manage these risks

Risks addressed / Policy objective

- Investor Protection
- Market Integration
- Macro- en micro-prudential risks

Scope Issues

All AIFM for each EU AIF it manages and for each of the AIF it markets in the EU

Option	Benefits	Costs	Evidence
Overview/summary:	Informed decision as on the part of the investor as to the risks involved; in particular cumulative risks concerning other investments already in the portfolio;	Compliance costs at AIFMs and regulators	Evidence of initial and incremental compliance costs in particular with regard to changes in strategy within portfolios (likely frequency of necessary updates).

Option 1 **Option 1 presented in Consultation Paper in relation to disclosure of 1) the current risk profile of the AIF; and 2) the risk management systems employed to manage these risks**: **1) Disclosure of current risk profile (Discretion for manager to determine appropriate disclosures):** ▪ Disclosure frequency in relation to align with the AIF's periodic reporting to investors. ▪ Disclosure to contain an assessment of the exposure of the AIF's portfolio to the most relevant risks to which the AIF is (or could be) exposed including where risk limits have been or are likely to be exceeded. Additional disclosure is required where the risk limits have been exceeded. **2) Disclosure of the risk management systems employed to manage these risks:** ▪ Overview of procedures employed to manage the most relevant risks to which the AIF is or may potentially be exposed should be made available to investors prior to investment. ▪ Thereafter disclosure triggered by a material change. Such disclosure to contain information relating to the change and its anticipated impact on the AIF and its investors.	Informed decision as on the part of the investor as to the risks involved; in particular cumulative risks concerning other investments already in the portfolio signalling effect for operational risks where identified risks are not properly managed;	Low as risk exposures should be known and risk management systems should exist as part of general good practices prior to the need to disclose them to investors;	Evidence of initial and incremental compliance costs in particular with regard to changes in strategy within portfolios (likely frequency of necessary updates) on a periodic basis.

Option 2 **Option 2 presented in Consultation Paper in relation to disclosure of 1) the current risk profile of the AIF; and 2) the risk management systems employed to manage these risks**: **1) Disclosure of current risk profile (Prescriptive requirements):** ▪ Disclosure frequency in relation to risk profile to align with the AIF's periodic reporting to investors. ▪ Disclosure to contain all the following: 1. identification of the most relevant risks to which the AIF is or could be exposed; 2. measures used by the AIFM to assess any sensitivity in the AIF portfolio to the most relevant risks to which the AIF is, or could be, exposed; and 3. the results of any relevant stress tests, or an indication as to whether, in the opinion of the AIFM, the exposure is likely to increase, is stable or is decreasing and within, near to, or exceeding risk limits set by the AIFM]. Additional disclosure is required where limits are exceeded. **2) Disclosure of the risk management systems employed to manage these risks: (same as option 1)**	Informed decision as on the part of the investor as to the risks involved; in particular cumulative risks concerning other investments already in the portfolio signalling effect for operational risks where identified risks are not properly managed;	Low as risk exposures should be known and risk management systems should exist as part of general good practices prior to the need to disclose them to investors; If measures are too prescriptive or specific may lead to difficulties in calibrating across different types of AIF	Evidence of initial and incremental compliance costs in particular with regard to changes in strategy within portfolios (likely frequency of necessary updates) on a periodic basis.

14.7. Box 108: Disclosure for each AIF of 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 leverage agreement.

Risks addressed / Policy objective

- Investor Protection
- Market Integration
- Macro-prudential risks - the objective is to enhance transparency of AIFM activity, including the systematic use of leverage, to enable the effective monitoring of systemic risks and to ensure that relevant macro-prudential data is shared at European level;
- Acquisition of control of companies by AIFM

Scope Issues

AIFM managing one or more EU AIF employing leverage or marketing in the EU one or more AIF employing leverage

Option	Benefits	Costs	Evidence
Overview/summary:	Identify players of systemic relevance through the disclosure of their leverage levels and ensure a proper macro-prudential monitoring of AIFMs and the AIFs they manage. Ability to focus action on AIFM of systemic relevance.	Calculation costs. Disclosure costs.	Evidence of current (if any) disclosure practices (frequency, detail of disclosure, current calculation methods). Evidence of preferred disclosure medium/media.

Option 1. **Option presented in Consultation Paper in relation to disclosure of changes to the maximum leverage level and related rights or guarantees:** Disclosure triggered by a material change Disclosure to contain the following information as appropriate: ▪ the original and revised maximum leverage level; ▪ the nature of the rights granted for the re-use of collateral; ▪ the nature of guarantees granted; ▪ details of changes in relevant service providers	Level playing field for AIFM and AIFs. Less uncertainty as to reasons for disclosure. Mitigate information asymmetry for investors.	Possible uncertainty as to the interpretation of 'material changes' and hence unequal trigger moments. Uncertainty by investors as to what constitutes material changes and as to whether there is leeway in interpretation at AIFMs. Costs for calculating, monitoring and disclosing changes (costs for calculating and monitoring may be low as exposures should be known internally at the AIFM as part of general good practices; disclosure costs may be low through disclosure via a website).	Industry input as to the definition of 'material changes'. Disclosure costs - input as to the preferences with regard to disclosure medium. Input on the possible format of disclosures.

14.8. Box 108: Disclosure for each AIF of the total amount of leverage employed by that AIF.

Risks addressed / Policy objective

- Investor Protection
- Macro-prudential risks
- Acquisition of control of companies by AIFM
- Market Integration

Scope Issues

AIFM managing one or more EU AIF employing leverage or marketing in the EU one or more AIF employing leverage.

Option	Benefits	Costs	Evidence
Overview/summary:	Identify players of systemic relevance through the disclosure of their leverage levels and ensure a proper macro-prudential monitoring of AIFMs and the AIFs they manage. Ability to focus action on AIFM of systemic relevance;	Calculation costs; Disclosure costs;	Input on calculation methodology (see other parts of the IA); Input as to preferences of disclosure medium;

Option 1: **Option presented in Consultation Paper in relation to disclosure of the total amount of leverage employed by an AIFM:** Disclosure frequency to align with the AIF's periodic reporting to investors Disclosure to contain 1) a description of the leverage measures or ratios and their appropriateness in relation to the investment strategy of the AIF; and 2) maximum leverage levels to which the AIF is subject.	Harmonised disclosure of leverage levels and furthering of the single market for AIF as leverage levels will be comparable across member states; Isolation of leverage as a driver of return within a peer group of AIFs - more granularity in due diligence for investors; Leverage levels may be used by investors as an indicator of return volatility (depending on the strategy) with regard to a particular AIF as well as a signal of vulnerability to certain exposures (debt etc); Better view on the sustainability of leveraged transactions; Regulators receive information to identify players of systemic relevance	Costs for AIFM should be low as disclosures are part of initial fund documentation or periodic reporting;	Evidence of current and preferred/possible disclosure practices prior to common regulation (frequency, detail of disclosure, current calculation methods)

14.9. Box 109: Specifying reporting obligations to competent authorities

Reporting obligations to competent authorities - specifying the obligations to report and provide information referred to in paragraphs 1 through 5. Those measures shall take into account the need to avoid excessive administrative burden for competent authorities. (No 39 in the mandate, Art. 24)

Risks addressed / Policy objective

- macro-prudential risk;
- micro-prudential risk
- investor protection
- acquisition of control (Articles 27 & 28) – to be discussed
- market integration

Scope Issues

No distinction in terms of category of AIF (hedge fund, real estate, etc). ESMA has considered a number of options in relation to the appropriate frequency of reporting and has debated as to whether frequency should be influenced by type of AIF (open-ended versus closed-ended), size of assets under management, frequency of portfolio turnover and whether the AIF uses leverage on a substantial basis. ESMA has determined that the reporting frequency should be the same for all type of AIFs.

Scenarios discussed:

- Open-ended & closed ended AIFs subject to the Directive and subject to registration requirements: quarterly reporting;
- open-ended AIFs with AUM < 1 bn: semi-annual reporting
- closed-ended AIFs with AUM < 1 bn: annual reporting;

- open-ended & closed ended AIFs > 1 bn: quarterly reporting;
- or all AIFS with substantial leverage additional information on leverage to be provided in accordance with Article 24(4)

Scenario proposed:

Open-ended & closed ended AIFs subject to the Directive and subject to registration requirements: quarterly reporting;

Competent authorities may also increase frequency of reporting.

Option	Benefits	Costs	Evidence
Option 1 presented in the consultation paper IOSCO template (in respect of reporting from hedge funds) has been tailored and expanded to apply to AIF of all types and to cover the reporting requirements of the Directive. AIFMs report on a quarterly basis to competent authorities. Competent authorities may also increase frequency of reporting	Enhanced transparency allowing for a better risk assessment / monitoring (including early warning system) of AIFM /AIF activity by regulators (home Member State AIFM, competent authorities of other relevant MS, ESMA, etc.) on the basis of up-to-date financial information. More particularly: High reporting frequency and same frequency of reporting for all the AIFs. Regular reporting to competent authorities for all AIFs	Incremental costs at industry level (compliance costs – set-up and on-going) and regulators level (set-up & on-going costs borne, if applicable, by industry and so final investors). <u>Industry / Regulator level</u> - Medium initial costs for setting up the reporting process at AIFM level for all AIFs, independent of reporting frequency and given that all information *a priori* already available in the organization; - High on-going cost for quarterly reporting process for AIFs	Feedback from consultation

Option 2 **Option rejected by ESMA** IOSCO template (in respect of reporting from hedge funds) has been tailored and expanded to apply to AIF of all types and to cover the reporting requirements of the Directive Content / frequency dependent on: Default reporting frequency proposed as follows: AIFM to report to competent authorities at a frequency varying according to their <u>assets under management</u> All AIFs > 1 bn: quarterly reporting; All AIFs < 1 bn: semi-annual reporting All AIFs subject to registration requirements (below Directive's thresholds): annual reporting Competent authorities may allow AIFM to report on a less frequent basis where appropriate after consideration of the stability and consistency of assets held taking in to account the frequency of portfolio turnover and the current or anticipated market conditions. For example where closed ended funds have low levels of turnover and market conditions are stable it is envisaged that it may be appropriate for them to report on a semi-annual basis where they have assets under management in excess of €1bn or on an annual basis where they have assets under management below this threshold. Competent authorities may also increase frequency of reporting Information to be provided to competent authorities within 60 days of a year-end submission and within 30 days of a semi-annual or quarterly submission.	Enhanced transparency allowing for a better risk assessment / monitoring (including early warning system) of AIFM /AIF activity by regulators (home Member State AIFM, competent authorities of other relevant MS, ESMA, etc) on the basis of up-to-date financial information. More particularly: Higher reporting frequency (quarterly) for certain AIFs: high benefit in terms of macro-prudential risk (market disruption); Regular reporting to competent authorities for all AIFs, frequency depending on nature, scale and complexity of AIF: high benefit in terms of micro-prudential risk and investor protection; Annual reporting (if sufficient for given type of AIF): keep administrative burden under control	Incremental costs at industry level (compliance costs – set-up and on-going) and regulators level (set-up & on-going costs borne, if applicable, by industry and so final investors). <u>Industry / Regulator level</u> - Medium initial costs for setting up the reporting process at AIFM level for all AIFs, independent of reporting frequency and given that all information *a priori* already available in the organization; - High on-going cost for quarterly reporting process for AIFs > 1 bn AUM - Medium (respectively low) on-going cost for AIFs < 1 bn AUM AIFs; - No significant indirect costs to be expected from reporting obligation, including no impact on efficiency of competition as level playing field ensured through consistent criteria.	Feedback from consultation Feedback from workshop Study on costs

Option 3 **Option rejected by ESMA: Specify reporting obligations in line with the following:** IOSCO template (in respect of reporting from hedge funds) has been tailored and expanded to apply to AIF of all types and to cover the reporting requirements of the Directive Content / frequency dependent on: type of AIF (open-ended versus closed-ended); and assets under management (incl. assets acquired by means of leverage) AIFM have to provide a core set of information for all AIFs, the frequency varying according to the type of fund (annually for closed ended and semi-annually for open-ended) Additionally open-ended AIFs with assets under management exceeding EUR 1 billion to report on a quarterly basis. No coverage of additional information/ad hoc information as laid down in Article 24(5) L1 Directive	Generally speaking: Enhanced transparency allowing for a better risk assessment / monitoring (including early warning system) of AIFM /AIF activity by regulators (home Member State AIFM, competent authorities of other relevant MS, ESMA, etc) on the basis of up-to-date financial information. More particularly: Higher reporting frequency (quarterly) for certain AIFs: high benefit in terms of macro-prudential risk (market disruption); Regular reporting to competent authorities for all AIFs, frequency depending on type of AIF: high benefit in terms of micro-prudential risk and investor protection; Annual reporting (if sufficient for given type of AIF): keep administrative burden under control	Incremental costs at industry level (compliance costs – set-up and on-going) and regulators level (set-up & on-going costs borne, if applicable, by industry and so final investors). <u>Industry / Regulator level</u> - Medium initial costs for setting up the reporting process at AIFM level for all AIFs, independent of reporting frequency and given that all information *a priori* already available in the organization; - High on-going cost for quarterly reporting process for AIFs > 1 bn AUM - Medium (respectively low) on-going cost for AIFs < 1 bn AUM of open ended (respectively closed ended) AIFs; - No significant indirect costs to be expected from reporting obligation, including no impact on efficiency of competition as level playing field ensured through consistent criteria.	Feedback from consultation Feedback from workshop Study on costs

14.10. Box 110 Leverage Reporting

Reporting obligations to competent authorities when leverage is considered to be employed on a substantial basis

Option	Benefits	Costs	Evidence
Option 1 Quantitative threshold	Easy to apply a threshold	Need for multiple thresholds, according to the different investment strategies of the AIF	
Option 2 AIFM's self-assessment based on qualitative criteria	Option takes into account the need to avoid excessive burden for competent authorities (art. 24.6 L1). Availability of proper information for the regulators in order to identify sources of systemic risks. Option permits the differentiation between diverse kind of AIFs limiting, at the same time, the discretionary power of the AIFM.	Subjectivity for AIFM in the verification of the 'threshold'. Risk of moral hazard/adverse selection in the self-assessment. Potential impact for the authorities: misjudgement in the contribution of leverage to the build-up of systemic risk. Incomplete information may affect the effectiveness of ESMA's powers in specifying remedial measures to be taken in case of substantial risk to the stability and integrity of the system (AIFMD, art. 25 § 7). Minimal harmonisation	

Option 3 Assessment based on criteria by the competent authority	Reduces the risk of inappropriate self-assessment.	Material administrative burden on competent authorities which is larger than the cost and risks of self-assessment by AIFM. Minimal harmonisation	

Annex IV

Feedback on the call for evidence and discussion paper

Feedback on the Discussion paper on ESMA's policy orientations on possible implementing measures under Article 3 of the Alternative Investment Fund Managers Directive (ESMA/2011/121).

Thresholds – calculation and oscillation

1. Do you agree with the proposed approach in relation to the procedure to identify the AIFs under management?

The approach proposed by ESMA was welcomed by all respondents to the consultation.

One respondent suggested that the rule applicable to UCITS management companies in identifying assets under management for capital requirements calculation purposes should apply. This would mean that AIFs managed by the AIFM including AIFs whose management has been delegated by the AIFM to other managers are taken into account. Assets of AIFs managed by the AIFM on the basis of a delegation from another AIFM or self-managed AIF should not be taken into account.

2. Do you agree that where available, the gross asset value for AIFs using leverage or net asset value for AIFs not using leverage should be used to calculate the total value of assets under management? Should ESMA consider the extent to which AIFs which produce gross and net asset values apply different valuation methodologies to the underlying assets?

One stakeholder supported ESMA's approach to include the assets acquired through leverage. However, this stakeholder stressed that there was a need for consistency between the calculation of the total value of asset under management and the definition of leverage that will be set out in the other part of the advice on implementing measures.

Another respondent considered that there should be consistency between the determination of total value of assets under management (and the determination of leverage) in this context and the determination of total value of assets under management (and definition of leverage) for other parts of the AIFMD. The same respondent considered that it would not be reasonable and could lead to confusion and entail additional costs if ESMA required application of a separate set of valuation standards for the purpose of calculating assets under management in this context.

According to one contributor, as private equity funds do not generally use leverage at the fund level, their gross and net asset values as defined and discussed in the consultation paper would be the same. For this respondent, a more relevant and more consistent approach to valuing a fund's assets would be the use of costs of investment.

Finally, one respondent was of the view that the approach should be fundamentally different depending on whether the relevant AIF is closed-ended fund or an open-ended fund. For open-ended funds, this respondent agreed with ESMA approach while for closed-ended one the threshold should be based on the maximum commitments/funds raising of an AIF.

3. Do you consider that where gross and net asset values are not calculated regularly the AIFM can include portfolio valuations, taking into account the type of underlying asset?

Most of respondents to the consultation agreed with the proposed approach to include portfolio valuations.

However, for one stakeholder, in the context of private equity, the more appropriate method would be the use of acquisition costs.

4. Can you suggest alternative approaches which could be used for AIFs which do not produce regular gross and net asset value calculations e.g. real estate, private equity? Can you provide information on best practice in relation to the calculation of the total value of the assets under management of AIFs in the sector in which you operate?

One respondent to the consultation suggested that for private equity funds, the calculation of the total assets under management should account for capital commitments while EVCA suggested the use of the method of the acquisition costs.

Another consultation believed that in respect of open-ended AIFs which so not produce regular NAV/GAV, ESMA may consider whether an approach based on the subscribed capital (varying depending on subscribed and redeemed out capital from time to time, but not through assets appreciate and depreciation) could be adopted. The same respondent also encouraged ESMA to look at industry standards depending on the relevant industry /sector (INREV, EVCA etc.).

Finally, it was suggested that for hedge funds the figures used are those which were last independently reviewed (i.e. with administrator or auditor) for NAV and adjusted by any mark to market as determined by the AIFM.

5. Do you have any other suggestions in relation to the procedure for calculating the total assets under management, including leverage?

One respondent was of the view that there should be a clear methodology in calculating the total assets under management, and that the definition of leverage should be consistent throughout the Directive to ensure consistency.

One contributor believed that there was no reason not to apply as far as possible the same rules to both open-ended and closed-ended funds, provided that these rules allow for enough flexibility to apply to both types of funds.

Some respondents believed that as far as possible the same rules should be applied to both open-ended and closed-ended funds. However, some members explicitly welcome the approach taken by ESMA which recognises that there may be a need for differentiation between open-ended and closed-ended funds for the calculation of the value of assets under management.

According to one contributor, the use of commitments less realisation would significantly overstate the assets under management in view of the fact that these commitments are generally drawn down for investments over a period of typically five years and in many cases the full commitment is never drawn and is therefore not an appropriate measure basis for measuring total assets under management

6. Do you agree that gross asset value, when available, is an appropriate measure of the leverage generated by the AIF?

One respondent disagreed with this proposal as the gross asset value only takes into account the profit and loss of the positions, not the actual exposure and believed that only the net asset value/commitment method should be used as the appropriate measure.

For one respondent gross asset value could be an appropriate method to measure the leverage generated by the AIF but only to the extent of committed capital. For example, any bridge loans that are assumed by the AIF in order to finance short term capital needs are to be excluded from this calculation unless they exceed the amount of unpaid committed capital.

Two stakeholders disagreed with this approach as they were of the view that the net asset value or commitment method would be more appropriate.

7. Can you suggest an alternative measure of leverage?

One respondent suggested that debt provided by third parties to AIFs for making investment and any collateral or guarantees issued by the AIF on the behalf of the portfolio companies (to the extent they exceed the amount of unpaid committed capital).

Two stakeholders explained that there should be consistency with the work carried out by the ESMA task force on leverage and the three methods identified for calculating the leverage (gross, commitment and advanced method).

8. In particular can you suggest a method by which leverage created at the level of an AIF-controlled entity, other than portfolio companies of private equity funds, can be captured in the calculation?

Two respondents asked for clarification on what was meant by 'an AIF-controlled entity, other than portfolio companies of private equity funds'. Furthermore, the same respondents generally believed that AIFMs could not be required to take into account leverage at the level of the underlying assets.

For one respondent it was not possible to capture the leverage created at the level of an AIF-controlled entity in a leverage calculation because this leverage could be changing on a continual basis.

For one contributor any liabilities or guarantees provided by AIF portfolio company entities should be excluded from this calculation unless the AIF is liable for them.

It was also suggested that leverage created at the level controlled entity should only be captured in the cases where it increases the exposure of the AIF.

According to one stakeholder leverage should only be taken into if:

- The relevant vehicle is specifically set up for the purpose of directly or indirectly creating leverage;
- Such leverage actually increases the exposure of the AIF.

9. Do you support the proposal for AIFs to calculate the total value of assets under management at least annually?

Most respondents agreed with the proposals.

10. Please provide your views on the impact of requiring the calculation of the total value of assets under management or monitoring it on a quarterly basis.

The vast majority of respondents were of the view that quarterly calculation of the total value of assets under management or monitoring it would be too onerous and burdensome. Took the example of real estate funds which have to resort to external valuers to determine the value of the assets in the portfolios of the AIFs they manage.

According to one respondent, quarterly calculation – especially for closed-ended AIFs - would be too onerous and disproportionate as well.

11. Can you suggest any alternative procedure for the calculation of the total value of assets under management throughout the period that would provide an accurate picture of the total assets under management?

One respondent suggested that in the context of private equity and venture capital funds, AIFs should use of the acquisition cost.

12. Do you have a view on which option ESMA should apply, taking into account that excluding cross-holdings may result in the exclusion of certain AIFMs which perhaps should be included (such as those managing significant master-feeder structures)?

The majority of respondents favoured option 2.

Two respondents suggested that 'internal funds' should use option 2 while 'non-internal funds' should use option 1.

One stakeholder suggested that whether or not to exclude cross-holdings should be left up to the manager and be indicated when reporting.

13. Please give reasons for your choice, taking into account the potential cost and administrative burden of excluding cross-holdings while considering the effect of leverage.

For the majority of respondents, option 1 would artificially increase the total asset under management.

14. Do you agree with the proposed approach to addressing circumstances where the threshold occasionally exceeds the limits?

Several respondents supported the proposed approach. One of them stressed that it should be the decision of the AIFM and not of the national authorities to assess whether the threshold was temporarily exceeded.

For another respondent there should be a buffer (for example 10%) to allow a flexible approach before authorisation is triggered.

Some stakeholders thought that the Level 1 text was sufficiently clear and that there should not be need for further implementing measures.

15. Do you have any alternative suggestions?

One respondent believed that seed capital from an AIFMD and/or its affiliates for the first twelve months should be excluded from the calculation of assets. Such exclusion would recognise the importance of seed capital in the hedge fund industry.

Registration procedure

16. Do you agree with the proposal to require information on the value of assets under management of AIFs? Please provide information on any potential cost impact.

Most respondents agreed with ESMA's proposal and supported the proposal.

However, one respondent pointed out that the ESMA's suggestion for AIFMs to notify the total assets under management upon registration was an additional requirement compared to the Level 1.

17. Do you agree with the minimum information which must be provided in relation to the AIF's investment strategy? Do you consider that the information requirement would be sufficient or can you suggest additions or amendments to the proposal?

One respondent stressed that some of the trusts managed were unable to provide original offering documents as they were traded in the secondary market. Therefore, this respondent was of the view that the requirements should reflect that in some circumstances, there will only be a secondary market and that offering documents are not relevant as shares are not obtained via the AIFM.

Two stakeholders thought that the description of the investment strategy should be strictly limited to the information described in Article 3(3) (c) to avoid any gold plating or any discretionary additional information request by member states.

Finally, two respondents agreed with the approach but stressed that it should be proportionate with regard to the structure of the AIFM.

18. Do you agree that the information referred to in Article 3(3) (d) should be provided at least annually?

According to most of respondents the information referred to in Article 3(3) (d) should be provided on annual basis and not more frequently.

One stakeholder agreed that for closed ended funds annual reporting was sufficient but suggested a 'no changes' type of reporting method for the funds whose reported information has remained unchanged since the previous annual update.

One contributor disagreed with an annual reporting and believed that information should be provided only in circumstances where material changes occurred.

19. Are there any other matters which should be considered?

Some respondents mentioned that it would be preferable if different means of communication (letter, fax, email, and web based form) be accepted for reporting to authorities so that managers may choose the most appropriate and efficient way of reporting.

20. Do you think that ESMA should be more prescriptive in relation to what constitutes a permanent or temporary increase above the threshold, for example by specifying the term 'occasionally'? Do you have any suggestions?

One respondent was against the requirement for AIFMs to seek for authorisation within 1 month if it is no longer able to rely on the exemption and believed that AIFMs should be given 1 year. The same respondent also stressed that the ESMA's proposal for AIFMs to monitor their total assets under management on a continuous basis to assess whether they can continue to avail the exemption implied that this should be done on a daily basis which would be too costly and add little benefit.

One stakeholder was of the view that it would be useful to be more prescriptive in relation to what constitutes a permanent or temporary increase above the threshold and proposed to define it as a continuous breach during the previous 3 quarters. AIMA also felt necessary for ESMA to be more prescriptive.

For several respondents, ESMA should not seek to define the term 'occasionally' further.

According to one contributor, for closed-ended private equity and venture capital funds the net asset value was not relevant and the commitments during the investment period and the cost of the portfolio less realisations after investment period should be the base for the calculation of the threshold. Therefore, there was no need for ESMA to be more prescriptive.

21. Do you have any alternative suggestions?

See question 20 above.

Opt-in procedure

22. Do you agree that all AIFMs which are obliged to be authorised, or which choose to be authorised under the opt-in procedure, should be subject to the same authorisation procedure under Article 7?

All the respondents to the consultation supported the approach that all AIFMs which are obliged to be authorised, or which choose under the opt-in procedure, should be subject to the same authorisation procedure under Article 7.

23. Do you agree that AIFMs previously registered under Article 3(2) of the AIFMD should submit all documents required under Article 7?

Most of the respondents to the consultation disagreed with the requirement that AIFMs previously registered under Article 3(2) of the AIFMD should submit all documents required under Article 7. According to them this would constitute an unnecessary burden for the AIFM and would generate unnecessary costs

24. Alternatively, should AIFMs only be required to submit information not previously provided for registration purposes and to update information previously provided?

In line with the question 23, most of the respondents supported the approach that AIFMs should only be required to submit information not previously provided for registration purposes and to update information previously provided.

25. Please provide justification for your preferred choice between the two alternatives set out under questions 23 and 24.

See responses to questions 23 and 24 above.

Feedback on the call for evidence published by CESR on possible implementing measures on AIFMD (Ref. CESR/10-1459)

Issue 2: Initial capital and own funds

Question 1: CESR is requested to provide the Commission with a description of the potential risks arising from professional negligence to be covered by additional own funds or the professional indemnity insurance (PII) referred to in Article 9(7).

One respondent pointed out that the express requirement for coverage of professional liability risks was not applied to UCITS managers or to MiFID investment managers subject to the Capital Requirements Directive and was only expressly required in the case of firms that are only authorised to provide the service of investment advice and/or receiving and transmitting orders. Therefore, pending future horizontal application of a requirement for coverage of professional liability risks, this respondent asked for AIFMD requirement to be applied on a flexible a proportionate basis.

One stakeholder believed that it was difficult to provide a description of potential risks as these risks will be changing due to changing circumstances, business models or risk crystallization. Instead of providing a description of the potential risks, the same stakeholder suggested allowing more flexibility by determining the high level risk groups which should be covered by the additional own funds or the professional indemnity insurance.

Finally, one respondent considered it somewhat arbitrary to develop a static list of risks which should be covered and noted that there was no such requirement under MiFID or UCITS.

Question 2: CESR is requested to advise the Commission on how the appropriateness of additional own funds or the coverage of the professional indemnity insurance to cover appropriately the potential professional liability risks arising from professional negligence referred to in Article 9(7) should be determined, including – to the extent possible and appropriate – the methods to calculate the respective amounts of additional own funds or the coverage of the professional indemnity insurance.

One stakeholder noted that currently firms already typically cover the potential risks arising from professional negligence through professional indemnity insurance as it can be used to finance large and unexpected liability claims, which are necessarily difficult to quantify in advance. Going forward, this respondent foresaw that most AIFM would seek to comply with this requirement by continuing to rely on their professional indemnity insurance policies on the grounds that: (i) this reflects current practice and will require minimal changes by the industry; (ii) many firms will find it inappropriate to their business structures to hold large amounts of 'excess' capital; (iii) effective risk assessment and risk control activities are likely to result in a lower risk profile, perhaps reducing the size of insurance premiums; and (iv) the calibration of capital requirements to the potential risks arising from professional negligence are likely to be complicated or inaccurate. Therefore, this respondent urged that the implementing measures did not add additional regulatory standards or requirements over and above those that are already applied in practice and recommended that the implementing measures made generic reference to industry-standard professional indemnity insurance coverage, rather than seek to specify the extent or quantum of coverage.

ESMA's attention was also drawn on the difficulty for internally managed funds to comply with the requirements of additional own funds or the coverage of the professional indemnity insurance.

Question 3: CESR is requested to advise the Commission on the best way to determine on-going adjustments of the additional own funds or of the coverage of the professional indemnity insurance referred to in Article 9(7).

According to one respondent, for level playing field reasons, the Insurance Mediation Directive (2002/92/EC) could be taken as a reasonable starting point for regulation. Indeed, the IMD requires the limits of indemnity to be reviewed every five years and to take into account movements in European consumer prices. The amount of additional own funds could be based upon the size of the policy excess (a larger excess requiring greater volume of additional own funds).

For one stakeholder, the amount of additional own funds could be based upon the size of the policy excess (a larger excess requiring greater volume of additional own funds) or could be based upon the income of the AIFM (the higher the income, the greater the likely impact of an incidence of negligence).

Question 4: CESR is invited to take account of work done in the context of the Capital Requirements Directive and to liaise as appropriate with CEBS and CEIOPS on this issue.

Some respondent agreed that account should be taken of work done in the context of the Capital Requirements Directive and that ESMA should liaise with EBA and EIOPA with a view to achieving as much cross-sector consistency on this issue as possible. However, ESMA was urged to ensure that these requirements were applied to AIFM in a flexible and proportionate manner, taking account of the many different types, business models and sizes of AIFM.

Two respondents reminded ESMA that the work undertaken in the context of the Capital Requirements Directive ('CAD') had not been finalised yet and that it might be premature at this stage to integrate it in this reflection.

It was also recommended that the costs for industry of introducing a requirement for AIFM based on the requirements set out in CAD Article 7 should be carefully examined

Issue 3: General principles

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

The Commission would encourage CESR to target an appropriate level of consistency with the corresponding provisions of other directives, such as UCITS and MiFID, while taking due account of the differences between the regulated populations.

The encouragement by the European Commission to ESMA to target an appropriate level of consistency with UCITS and MiFID was overwhelmingly welcomed by respondents to the call for evidence. However, most of them pointed out that the principle of proportionality should be respected in order to take into account the nature and the diversity of the types of AIFs.

Issue 4: Conflicts of interest

Question 1: CESR is requested to provide the Commission with a description of the types of conflicts of interests between the various actors as referred to in Article 14(1).

Many respondents to the call for evidence encouraged ESMA to developing draft implementing measures consistent with the MiFID and UCITS Directives.

One stakeholder stressed that investors in private equity and venture capital funds considered carefully the issue of conflicts of interest and usually negotiate strict clauses to ensure disclosure of any kind of conflict of interest and approval requirements by the investor committee in case conflict arises. This stakeholder recommended ESMA to consider IOSCO's November 2010 final report on Private Equity Conflicts of Interest.

Question 2: CESR is requested to advise the Commission on the reasonable steps an AIFM should be expected to take in terms of structures and organisational and administrative procedures in order to identify, prevent, manage, monitor and disclose conflicts of interest.

The Commission would encourage CESR to target an appropriate level of consistency with the corresponding provisions of other directives, such as UCITS and MiFID, while taking due account of the differences between the regulated populations.

One respondent noted that the reasonable steps an AIFM should be expected to take in terms of structures and organisational and administrative procedures in order to identify, prevent, manage, monitor and disclose conflicts of interest covered in the AIFMD Level 1 text were areas that were adequately covered by existing legislation. In particular, these steps were set out in MiFID, which specifically provides for and establishes, at Levels 1 and Level 2, appropriate criteria for defining the steps that investment firms might reasonably be expected to take to identify, prevent, manage and/or disclose conflicts of interest. Again, this stakeholder believed it was vital that the implementing measures should not add new, different or additional regulatory standards or requirements over and above those that were already applied to regulated fund managers, through existing legislation governing regulatory standards applying to authorised firms, such as MiFID.

Another respondent welcomed the encouragement by the Commission to ESMA to target an appropriate level of consistency with UCITS and MiFID frameworks while taking due account of the differences between the regulated entities. According to the same respondent, Level 2 measures should be closely aligned with implementing provisions for UCITS Directive and MiFID.

Issue 7: Investment in securitisation positions

CESR is invited to advise the Commission on the content of rules that are necessary and proportionate for an AIFM to fulfil its obligations under Article 17.

In particular, CESR is invited to advise on:

a) the requirements to be met by the originator, the sponsor or the original lender, in order for an AIFM to be allowed to invest in securities as defined in Article 17.

b) the qualitative requirements to be met by an AIFM in order to comply with their obligations under Article 17.

In developing this advice, CESR is invited to take full account of the content of the relevant articles of the Capital Requirements Directive and of measures developed for the same purpose in the context of other legislation, notably Solvency II.

One respondent did not see any grounds for requiring AIFM to take regulatory responsibility for ensuring that relevant interests are monitored or otherwise in relation to requirements concerning securitisations that are eligible for AIF investment. According to this respondent, compliance with relevant obligations should expressly be the responsibility of those structuring / originating the relevant securitisation. It should then be for a regulated entity involved in such structuring to warrant to an AIFM that it has taken all necessary steps to comply with the relevant requirements. Having obtained such a warranty from a regulated firm, the AIFM should be able to rely on this and, consequently, able to invest without being required to make further inquiry.

As a general remark, another stakeholder had strong concerns regarding the applicability of the requirements set out in Article 17 of the AIFMD to securitisation positions issued after 1 January 2011. While the requirements already apply to any securitisation position issued after 1 January 2011, the future implementing measures of the AIFMD are still unknown and will not become binding at national level for several years. This could create a legal uncertainty for AIFM regarding the conditions for investing such securities. Therefore, this stakeholder suggested that ESMA should advise upon a practicable approach to this issue. As regards obligations on the AIFM, according to EFAMA, checking that the sponsor/originator has published the required commitment prior to purchase should be sufficient for asset managers. The primary obligation here is on the originators. AIFM, and other types of investors, must be able to rely on statements published by them, and there is no good reason to place greater due diligence obligations on AIFMs than on other investors. As regards the qualitative standards mentioned in question 2b), EFAMA urged ESMA to bear in mind the practicability and reasonableness of the overall approach. EFAMA believed that for an investor, it is impossible to monitor on an on-going basis that the retention is maintained by an originator. Furthermore, there are no provisions as to where the issuer has to disclose this information.

Finally, ESMA was informed that private equity and venture capital funds did not invest in such products.

Issue 8: Organisational requirements

Question 1 CESR is invited to advise the Commission on the content of rules that are proportionate and necessary for specifying the general obligations placed on an AIFM by Article 18(1).

Question 2: In particular, CESR is requested to advice on the procedures and arrangements to be implemented by the AIFM, having regard to the nature of the AIF managed by the AIFM, in order to comply with its obligations under Article 18(1).

One respondent's main concern in relation to this Article and implementing measures relating to it was to ensure that, where existing rules apply to AIFM that are authorised prior to the implementation of the Directive, that the Directive did not have the effect of duplicating or otherwise changing existing rules. According to this respondent, the approach should be to utilise existing regulatory requirements, particularly those derived from MiFID, rather than to create any duplicative or overlapping requirements. These types of rules should also take into account and be applied in a way that is proportionate to the size and scale of individual AIFM to which they are applied. Consequently, therefore, the implementing measures should state expressly that it is permissible for a small AIFM to have less extensive human and technical resource than a larger AIFM might need and that AIFM should be allowed (and required) to have in place such resources that are appropriate and proportionate to their respective businesses.

According to one stakeholder, existing legislation under both the UCITS and MiFID rules should serve as a starting point for implementing measures regarding organizational requirements. In many cases AIFM act as UCITS management companies and/or MiFID firms so consistency in processes would be highly desirable. However, given the very broad scope of the AIFMD, neither the UCITS nor MiFID rules can in their existing form provide appropriate regulation on all issues covered in the mandates by the Commission. The UCITS and MiFID rules should therefore serve as basis for ESMA's drafting but the AIFMD Level 2 rules should be prepared in a proportionate and differentiated way in order to take into account the wide variety of structures under the scope of the AIFMD. Due consideration should however be given to the differences between AIFM and AIF on the one hand and the MiFID Firms UCITS Management Companies and the UCITS on the other hand.

For some stakeholders the requirements should be in line with those applying to UCITS managers, unless a differentiation is duly justified by the specific nature of AIFs.

Issue 9: Valuation

CESR is invited to advise the Commission on:

Question 1: The criteria concerning the procedures for the proper valuation of the assets and the calculation of the net asset value per share or unit to be used by competent authorities in assessing whether an AIFM complies with its obligations under Article 19(1) and Article 19(3).

CESR is invited to consider how these procedures should be differentiated to reflect the diverse characteristics of the assets

in which an AIF may invest.

According to one stakeholder, ESMA should take both the IOSCO Principles and the AIMA Valuation Sound Practices Guide into consideration when considering the criteria for procedures for proper valuation and NAV calculation. Indeed, the same stakeholder stressed that were no generally applicable procedures for valuation of assets and or for calculation of NAV in the EU, and in practice the valuation and NAV calculation procedures followed by AIF were usually set out in their prospectus or equivalent offering document, or occasionally in their constitutional documents, and not in legislation. It was the respondent's view that, provided that the policies and procedures were documented and consistently applied and reviewed periodically for their continued appropriateness and that appropriate disclosure was made to investors of the valuation policies and of any material involvement of the AIFM in the process, there should be flexibility to tailor them to the relevant assets and AIF. The procedures for valuation of assets and calculation of NAV should not be rigidly laid down in legislation.

For some respondents, the Level 2 measures should concern the governance and oversight of the valuation process, including roles and responsibilities, the existence of pricing policies, pricing committees, fair value pricing and so on. They also further underlined the importance that any measures should recognize existing regulatory and industry standards, among them the IOSCO principles for hedge fund valuation in 2007 and the Hedge Fund Standards Boards standards for valuation of hedge fund assets.

Finally one respondent deemed necessary to specify that, given the diversity of assets invested in by AIFs, it was essential that ESMA focuses on the criteria concerning the procedures and not on the procedures themselves. Secondly, any measures should recognise existing regulatory and industry standards (IOSCO, BVCA and EVCA guidelines)

Question 2: The type of specific professional guarantees an external valuer should be required to provide so as to allow the AIFM to fulfil its obligations under Article 19(5).

CESR is asked to consider the impact of the required guarantees on the availability of external valuers to the AIFM industry.

According to one stakeholder, adequate professional safeguards should be available through two mechanisms:

- through auditors to an AIF in respect of the financial statements;
- by way of a SAS 70/ISAE 3402 study in respect of the external valuer.

For another respondent, the use of the word 'guarantees' in this context was somewhat confusing and the word 'warranties' would be more appropriate since it refers not to a financial guarantee but to a warranty that the valuer has the necessary qualification for the role.

Question 3: The frequency of valuation carried out by open-ended funds that can be considered appropriate to the assets held by the fund and its issuance and redemption frequency.

In particular, CESR is invited to consider how the appropriate frequency of valuation should be assessed for funds investing in different types of assets and with different issuance and redemption frequencies, taking into account different (and varying) degrees of market liquidity. CESR is invited to take account of the fact that such valuations shall in any case be performed at least once a year.

For one stakeholder, any attempt to define the appropriate frequency of valuation needs to take these issues fully into account. If full flexibility was not preserved, the potential outcome would be to put unnecessary additional costs of providing more frequent valuations onto the fund and indirectly investors.

ESMA was asked to abstain from defining specific valuation cycles but rather, to develop general criteria for assessment of appropriate frequency of valuation by

AIF. In the context of open-ended funds, it is the NAV calculation frequency which should be closely correlated with the issuance and redemption policy of an AIF in

order to allow for effective pricing of fund units. The official net asset value of an open-ended AIF should therefore be calculated at least each time there are or may

be subscriptions or redemptions in the AIF.

For one contributor, this was a complex issue and inextricably linked to the liquidity policy. However, it was pointed out that that the robustness of the valuation policy rather than the valuation frequency that was most important for open-ended funds.

According to one respondent, in the context of open-ended funds, while the types of assets held by the AIF may determine to an extent the frequency of valuations, the most important factor was the frequency of the dealing arrangements of the AIF.

Two respondents thought that ESMA should base its answer on the valuation standards generally recognised by investors and other stakeholders of the various assets classes covered by the AIFMD and recommended that ESMA promote the use of these standards the IPEV Guidelines developed by the private equity and venture capital industry.

Issue 10: Delegation

Question 1: CESR is invited to advise the Commission on the content of rules that are necessary and proportionate to ensure that an AIFM fulfils the conditions under Article 20(1) and Article 20(2).

One stakeholder made the comment that many firms which fall within the scope of the Directive operate globally and therefore the rules should not be such as to impede the ability of AIFM to delegate for proper commercial purposes and operate within the competitive global market for asset management services. According to this respondent, the onus should be on the AIFM to ensure (i) that the delegate is aware of the provisions of the AIFM Directive, (ii) that the terms of the delegation agreement are not contrary to the terms of the AIFM Directive and (iii) that the AIFM must adequately supervise and monitor the carrying out of the delegated functions such that the arrangement is not a mere 'letter box' whereby matters merely pass through the AIFM with all active functions being performed by the delegate.

Some respondents felt that the requirements should similar to those under MiFID.

- Delegation to group entities/associates should also be subject to less rigorous controls.

- One should also consider what functions are covered by the undefined term 'portfolio or risk management'. The term 'management' means that this should focus on ultimate decision making ability in the relevant areas.

- It should be made clear that where for whatever relevant local reasons the proposed delegate is not authorised or registered for the purpose of asset management and the competent home Member State authorities, acting reasonably, have not approved delegation of a management function the AIFM should nonetheless be able to take advice from such entity in continuing itself to exercise the management functions.

Question 2: In particular, CESR is invited to advise the Commission on the following, which are applicable both to cases of delegation and sub-delegation:

a) the criteria that competent authorities should use to assess whether the reasons supplied to justify the entire delegation structure of an AIFM are objective.

For one respondent, any list of criteria used to assess the rationale for delegation should be non-exhaustive so as to allow for evolutions of business models in the light of developing markets or investor needs. For this stakeholder it was clear from Recital 22 of the AIFMD that an AIFM shall be permitted to delegate so as to increase the efficiency of its business and therefore suggest that those criteria should include:

- specialist expertise where outsourcing is appropriate;
- time zones/market opening hours;
- efficient structuring of investments;
- local expertise;
- staff availability;
- other resources;
- investor requirements;
- local legal or regulatory requirements.

It was one respondent's position that, given the wide range of AIF and AIFM covered by the AIFMD, it was difficult to define an exhaustive list of criteria to use to assess whether the reasons supplied to justify the entire delegation structure of an AIFM are objective. Therefore, this respondent urged ESMA to seek a flexible and proportionate approach. Instead, categories of criteria could be provided, leaving enough flexibility to regulators to consider each individual case.

According to another contributor, the relevant criteria should in the first place encompass possible efficiency gains, increase in service quality, avail of specialised expertise, cost savings and explicit client requests (in case of AIF with a limited number of investors).

Finally, for one respondent, objective reasons for delegation will include, for example, securing a firm's skills and experience in:

- managing specific asset classes;
- operating in specific geographical markets;

- managing back-office, legal, tax or other compliance tasks.

b) the circumstances under which a delegate should be considered to have sufficient resources to perform the tasks delegated to it by an AIFM; and to be of sufficiently good repute and sufficiently experienced to perform these tasks.

For one contributor, Article 20 provides that the AIFM's liability to the AIF and investors will be unaffected by any delegation or sub-delegation. We would also expect that the AIFM will be in the best position to judge whether the delegate has the necessary resources, operational reputation and experience. Primary responsibility for assessing the resources, reputation and experience of any delegate (or sub-delegate) should therefore sit with the AIFM. According to this contributor, the AIFM should be required to put in place documented policies and procedures to be followed when considering delegation which should include the factors to be taken into account. These factors would include:

- whether the delegate customarily provides services in this area;
- whether the relevant employees of the delegate have appropriate experience;
- whether the delegate has sufficient resources to meet its obligations;
- whether the delegate has been subject to any regulatory sanction relevant to the services to be provided.

According to one stakeholder, for a delegated entity which is an authorized or registered entity, these criteria should be assumed as satisfied by fact of the entity's continued authorization or registration. Where authorization or registration is not mandatory for a delegated entity, the competent authority may proceed with an objective test to ensure that the right to delegate is not abused. In view of such tests criteria should be defined and applied instead of leaving the determination of the test in each individual case, to give market participants necessary certainty and predictability ex ante.

One respondent was of the view that it should be automatic that any firm authorised to conduct business under MiFID meets the standards required of a firm carrying out delegated functions. According to the same respondent, where a firm did not have MiFID authorisation, the criteria used for MiFID approval should provide the basis for the standards set out in Level 2.

c) the types of institutions that should be considered to be authorised or registered for the purpose of asset management and subject to supervision. CESR is invited to consider whether to employ general criteria or to specify categories of eligible institution in this context.

According to one respondent, were the delegate is based in a member state, general criteria stating that authorisation/registration from the competent authority in the delegate's home state should suffice. In other instances, the requirements should be met if the delegate:

(i) is subject to supervision of a regulator with whom appropriate co-operation arrangements for the purposes of Chapter VII of the Directive (Specific Rules in relation to Third Countries) or is subject to regulation for asset management by a regulator which is a member of IOSCO;

(ii) where not regulated in its third country or regulated by a regulator within item (i) above, is first notified to the AIFM's competent authority and that authority does not object within a period of notification.

One other stakeholder suggested employing a combination of general criteria and specific categories to cover easily identifiable categories of entities, but also allow proportional flexibility for the heterogeneous nature of AIF structures and asset managers. MiFID firms capable of performing asset management, UCITS firms and

AIFM entities (excluding self-managed AIFM) should automatically be considered suitably authorised. For non-EU entities, authorisation/registration with local

competent authorities should be sufficient.

d) in the event of a delegation of portfolio or risk management to an undertaking in a third country, how cooperation between the home Member State of the AIFM and the supervisory authority of the undertaking should be ensured.

For one stakeholder this question followed from the proposed delegates referred to in Question 2 (c) that such co-operation will be an inherent or implied feature of the permitted delegation or that the delegate will be part of a group of companies with presence in a Member State through which co-operation may be sought.

One respondent supported cooperation between the supervisory authorities by a simple cooperation/information sharing agreement which takes account of recent IOSCO standards and recommendations.

e) the circumstances under which a delegation would prevent the effective supervision of the AIFM, or the AIFM from acting, or the AIF from being managed, in the best interest of its investors.

According to one respondent, the proposed structure of the delegation regime should prevent such situations.

One stakeholder was of the view that it was difficult to define circumstances under which a delegation would prevent the effective supervision. In this context, it reminded ESMA that one of the conditions to be complied with for delegation is that the delegation should not prevent the effectiveness of supervision of the AIFM and that in case of delegation, the AIFM's liability towards the AIF and its investors will not be affected by the fact that the AIFM has delegated functions to a third party. Therefore, this respondent did not consider it necessary to define such circumstances.

Question 3: CESR is invited to advise the Commission on the content of rules that are necessary and proportionate to ensure that an AIFM fulfils the conditions under Article 20(3).

ESMA did not receive a lot of feedback on this question. However, one respondent believed it was difficult to conceive that further detailed rules were required with respect to sub-delegation provided the AIFM is required to ensure compliance with these requirements in its arrangements, and is given sufficient information rights to assess compliance, with its delegates.

Question 4: In particular, CESR is invited to advise on:

a) **the type of evidence necessary for an AIFM to demonstrate that it has consented to a sub-delegation.**

For some respondents, any such consent should be given in writing either by way of a separate written consent or by the AIFM being party to the sub-delegation agreement but the latter was desirable since the AIFM may wish to sue the sub-delegate where it faces potential liability to investors.

For one stakeholder, consent should simply be demonstrated by the AIFM in writing confirming its consent to the sub-delegation to the delegate. For this stake-

holder it should not be necessary for the AIFM to be party to a sub-delegation agreement - such a requirement would be administratively burdensome and would

lengthen the time taken to negotiate sub-delegation agreements. The AIFM (and indirectly the AIF) should be adequately protected in respect of any sub-delegations via the delegation agreement.

b) the criteria to be taken into account when considering whether a sub-delegation would result in a material conflict of interest with the AIFM or the investors of the AIFM; and for ensuring that portfolio and risk management functions have been appropriately segregated from any conflicting tasks; and that potential conflicts are properly identified, managed, monitored and disclosed to the investors of the AIF.

For respondent to the call for evidence, conflicts of interest might arise:

- where the delegate is part of a group whose commercial or other interest might compete with or be inconsistent with those of AIFM or investors of the AIF;
- where the delegate provides services for other parties whose commercial interests might compete with or inconsistent with those of the AIFM or investors of the AIF.

According to the same respondent, each AIFM should have a conflicts of interest policy to identify, manage and monitor conflicts of interest and that policy should be disclosed to investors of the AIF. Furthermore, that policy should also be provided to any delegate where appropriate and be reflected as appropriate in any agreement with such delegate. Finally, the delegate should also have a conflicts of interest policy which should be compatible with the agreement with the AIFM but should also detail arrangements in place (including record keeping procedures to permit monitoring of the necessary requirements, information barriers to safeguard confidential information and restrictions on personal dealings by staff) so as to be consistent with those arrangements.

One stakeholder stressed that it was generally understood that conflicts of interest did exist and that the portfolio management and risk management functions may not be capable of segregation from all conflicting tasks. For this stakeholder, conflicts of interest need to be suitably managed and properly disclosed to investors.

For another respondent to the call for evidence, one case of potentially diverging interests might be delegation / sub-delegation of portfolio management to an AIF investor.

c) **the form and content the notification under Article 20(3) (b) should take in order to ensure that the supervisory authorities have been properly notified.**

According to one respondent, in line with MiFID, it should not be prescribed at Level 2 but instead be a matter for each local regulator in terms proportionate with the particular proposed delegation.

It was also suggested that supervisory authorities could be properly notified by a written notification, containing details of the delegated entity and its competent authority (if authorised/registered), confirmation that the AIFM consents to the delegation, the relevant AIF(s) which are affected by the delegation, and the intended effective date of the delegation.

Question 5: CESR is also invited to advise the Commission, in relation to Article 20(2), on the conditions under which the AIFM would be considered to have delegated its functions to the extent that it had become a letter-box entity and could no longer be considered to be the manager of the AIF.

One respondent stressed that both the UCITS IV Directive and MiFID contain a similar provisions; neither defines the term 'letter-box entity'. For this respondent, given that delegation of the portfolio management and risk management functions is permitted, the steps necessary for the delegating AIFM not to be a letter box may require some form of on-going consultation on a regular basis with the delegate, reporting, stress testing etc. such that the AIFM does not lose the ability to supervise and, if necessary, to intervene. In addition, this stakeholder felt that the authorities should remain satisfied that those within the AIFM retain sufficient expertise, resource authority and information to properly oversee the activities of the delegates conducting the portfolio and risk management functions delegated to them.

As a general rule, one stakeholder agreed that the UCITS Directive and its implementing measures should be the model for implementing measures for the AIFMD delegation. According to this respondent, ESMA should avoid direct application of UCITS management company guidance without considering the fuller range of AIFs, AIF structures and their managers.

For one respondent to the call for evidence, an AIFM delegating functions to other entities must in any case retain the necessary resources and expertise in order to effectively control performance of the delegated functions and to adequately manage the related risks. For another respondent an AIFM was not a letter-box entity as long as it could control the delegations and that it performed at least one of the investment management functions listed in Annex I of the Directive.

Finally it was stressed that where an AIFM maintains responsibility for decision making in these areas it would not be a 'letter box entity' and that an AIFM could practically demonstrate that these decisions are retained by the AIFM by providing evidence:

- of constitutional or other legal arrangements which reserve decision making on these issues to the AIFM;
- of service contracts which set out the extent of, and limit, the supplier/s role;
- that the AIFM is able to terminate delegation arrangements (subject to reasonable contractual considerations);
- that firms undertaking delegated functions provide adequate reports to the AIFM which allow the monitoring of the supplier's activity;
- (such as meeting minutes) that demonstrate the AIFM regularly reviews the work undertaken by firms carrying out delegated functions;
- (such as meeting minutes) which demonstrate that the AIFM regularly considers the issues over which it retains decision making responsibility (asset allocation, leverage levels, the continued appointment of suppliers etc.);
- that the AIFM signs-off the content and publication of the annual report and accounts, other financial and regulatory statements and investor communications.

Part II: Depositary

General comments

One respondent identified the impact of the depositary requirements on the role of the prime broker as a crucial element. This respondent felt that three options were available for the provision of prime brokerage services:

i) Prime broker provides both counterparty and custodial services; it has the functional and hierarchical separation required by Art. 21(4) and is appointed as depositary of the AIF.

ii) Prime broker provides custodial and counterparty services (the prime broker is effectively the sub-custodian in this case). This respondent felt that the selection of a particular prime broker and the provision of custody services as an important part of the arrangement should be considered as a sufficient and objective justification for both the delegation of custody functions to the prime broker and assumption of liability by the sub-custodian (subject to agreement by the parties). AIMA nevertheless requested that this be clarified in the L2 work.

iii) Prime broker holds assets as a counterparty but does not provide custodial services (i.e. does not act as a depositary). In this case the depositary provisions should not be relevant to the prime brokerage arrangements.

One respondent asked for a list to be developed setting out which institutions or persons should be entitled to act as depositary of AIF in each member state. In this context, the same respondent was of the view that auditors should be able to act as depositaries.

Issue 11 – Contract evidencing appointment of the depositary

Question1: CESR is requested to advise the Commission on the necessary particulars to be found in the standard agreement evidencing the appointment of the depositary. In its advice, CESR should take into account the consistency with the respective requirements in the UCITS Directive.

Two respondents supported aligning the requirements on depositaries with the UCITS and MiFID provisions, unless the specificities of the AIF (e.g. legal structure) justified tailored provisions. In particular, one of them saw Article 30 of the Directive 2010/43/EU as a relevant framework for the content of the agreement, subject to appropriate adaptation. Finally, the same respondent called for sufficient flexibility in the list of contents to allow the parties to fine-tune the agreements as needed.

One respondent believed that the provisions of UCITS were not necessarily appropriate to AIF due to the different roles of the depositary in each case and the much broader range of assets in which AIF may invest. Nevertheless, this respondent identified the following as potentially useful in terms of obligatory inclusion in the agreement:

- a description of the procedures to be followed where the AIFM envisages a modification of the AIF rules or instruments of incorporation, and identifying when the depositary should be informed, or where a prior agreement from the depositary is needed to proceed with the modification;
- a description of the means and procedures by which the depositary will have access to all relevant information it needs to perform its duties;
- provisions relating to the exchange of information in relation to the sale, issue, repurchase, redemption and cancellation of AIF shares/units;
- provisions relating to confidentiality and anti-money laundering obligations;
- provisions relating to the amendment and termination of the agreement.

Another stakeholder identified the following elements as being relevant for inclusion in the agreement:

- identifying the types of asset covered and whether any are subject to special custody arrangements

- requiring segregation of the assets of the AIF from those of the AIFM or depositary but leaving flexibility on how this is done
- minimum information required by the depositary from each AIFM in order to enable it to perform its duties
- minimum information and service levels required by the AIFM from each respective type of depositary
- duties and responsibilities of the depositary under the Directive
- permitted powers of delegation of custody.

Question 2: CESR is encouraged to provide the Commission, if possible, with a draft model agreement.

Many respondents to the call for evidence were against the development of a model agreement on the basis that this was not required by the L1 text, such a model could not take into account the broad range of AIF, there would be difficulties of interpretation with respect to national legal frameworks and it would restrict commercial freedom. If there were to be a model agreement, one of them felt that it should not go beyond the matters identified above in response to Q1. Several respondents suggested that the advice should cover only a list of areas that such agreements should include (in line with the UCITS IV approach) and made specific suggestions in that regard. One of them saw merit in identifying a list of key non-negotiable terms to be included in the agreement, leaving flexibility to the parties to elaborate further.

One stakeholder felt the agreement should explicitly address the following elements:

- First, the cases for exemption of liability for the depositary should be reduced to an only strictly necessary minimum;
- Second, the depositary should not be allowed to add extra obligations for AIFMs beyond this list of obligations and mentions to be provided by ESMA.

The same respondent also warned against allowing flexibility on the content of contracts depending on the 'rapport de force' between the depositary and the AIFM on the basis that this would lead to diverse outcomes and lower investor protection.

Issues 13.1 – Depositary functions pursuant to paragraph 6

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

- the AIF's cash flows are properly monitored;

- all payments made by or on behalf of investors upon the subscription of shares or units of - an AIF have been received and booked in one or more cash accounts opened in the name of the AIF or in the name of the AIFM acting on behalf of the AIF or in the name of the depositary acting on behalf of the AIF at an entity referred to in Article 18 (1) (a) to (c) of Commission Directive 2006/73/EC in accordance with the principles set forth in Article 16 of Commission Directive 2006/73/EC.

- where cash accounts are opened in the name of the depositary acting on behalf of the AIF, none of the depositary's own cash is kept in the same accounts.

One respondent felt that for each of the functions, the depositary's responsibility should be limited to checking that adequate and appropriate processes and procedures are in place and periodically checking that these procedures remain adequate and appropriate, and are complied with (rather than, for example, verifying that every single subscription payment is received and booked in an appropriate cash account). In this context, this respondent noted that the depositary should also take account of reports received from service providers such as prime brokers.

Two stakeholders took a similar view. Two respondents agreed with the principle that cash assets belonging to the AIF should not be kept in the same accounts as cash belonging to the depositary.

One contributor also felt that for subscription monies, it should be possible for the AIFM to open one cash account into which subscription monies received in respect of several AIF may be paid. In this context, this contributor noted that listed entities generally appointed receiving bankers for subscription monies and that this would generally not be the depositary.

According to one stakeholder, sub-custodians should segregate cash in three accounts: own cash, investment fund cash and other clients' cash. The same respondent felt that it should be possible to differentiate at all times cash in foreign currency kept abroad by the sub-custodian from cash belonging to its other clients, the ultimate objective being to guarantee the ability to return the relevant cash to the appropriate clients. However, this respondent saw no need to differentiate the requirements according to the type of AIF as this could lead to regulatory arbitrage and noted that there was currently no harmonised definition of closed-end or open-ended funds.

One respondent requested that the advice clarify that law firms and professional administration firms are able to provide depositary services. The same respondent explained that private equity and venture capital funds generally work on a 'cash to cash' basis, namely that regardless of when an investor commits to a private equity or venture capital fund, the cash will only flow from the investor to the AIF around the time when the investment is made, and cash will be returned from the AIF to the investor when an investment is sold. The same respondent also felt that the advice should not put in place additional steps in the investment process which could delay the receipt of new financing for investee companies. Regarding the depositary's duty to monitor cash flows in particular, this respondent felt it should be sufficient for the depositary to receive reports or audited financial statements.

One stakeholder sought clarification that the monitoring of cash flows by the depositary should not be interpreted as requiring the insertion of an additional account with the depositary through which all funds must flow, nor that it be required to sign off on every cash movement. The respondent was of the view that any such requirements would introduce significant delays to the flow of funds into investments. It also asked whether the Level 1 provisions prevented a depositary which is a bank being one of the entities at which cash accounts are held and whether the normal debtor/creditor relationship would be changed under AIFMD (reference was made to the MiFID client money provisions and the absence of any equivalent in AIFMD).

Question 2: CESR is requested to advise the Commission on the conditions applicable in order to assess whether:

- an entity can be considered to be of the same nature as the entity referred to in Article 18 (1) (a) to (c) of Commission Directive 2006/73/EC, in the relevant non-EU market where opening cash accounts on behalf of the AIF are required;

- such an entity is subject to effective prudential regulation and supervision to the same effect as the provisions laid down in European Union law and which is effectively enforced.

One stakeholder considered that any entity established in the relevant third country should be considered 'of the same nature' as those entities referred to in Article 18 (1)(b) of Commission Directive 2006/73/EC if it is a credit institution subject to prudential regulation and supervision to the same effect as the provisions laid down in EU law. The stakeholder also suggested that ESMA's advice should be to accept that any entity which meets such equivalence regime, as is currently expected to be developed for such entities as a result of the responses from the current Commission consultation on the reform of MiFID dated 8 December 2010, as automatically being of the same nature as such entities as are referred to in Article 18 (1)(a) to (c) of Commission Directive 2006/73/EC.

One respondent noted that the entities referred to in Art. 18 of MiFID Level 2 Directive included central banks and any bank authorised in a third country; as such, it felt that the conditions to be developed by ESMA would relate only to the identification of other types of third-country credit institution suitable for this purpose.

Question 3 CESR is requested to advise the Commission on the conditions applicable in order to determine what shall be considered as the relevant market where cash accounts are required.

One respondent to the call for evidence disagreed with the Commission's interpretation of Art. 21(6), i.e. that the depositary is required to ensure that all AIF cash is booked in cash accounts in the name of the AIF/AIFM or (where required in the relevant market) in the name of the depositary. The respondent's view was that the provision did not limit the circumstances in which AIF cash may be booked in cash accounts in the depositary's name, and that any other interpretation would be inoperable in practice and would not delivery any regulatory benefits.

Another respondent took the view that it should not be necessary to have a cash account for each jurisdiction in which a transaction is carried out, and that it should be sufficient for e.g. completion monies to be paid to the lawyer acting on the transaction.

Issues 13.2 – Depositary functions pursuant to paragraph 7

Question 1: CESR is requested to advise the Commission on:

- **the type of financial instruments that shall be included in the scope of the depositary's custody duties as referred to in point (a) of Article 21(7), namely (i) the financial instruments8 that can be registered in a financial instruments account opened in the name of the AIF in the depositary's books, and (ii) the financial instruments that can be 'physically' delivered to the depositary;**

- **the conditions applicable to the depositary when exercising its safekeeping custody duties for such financial instruments, taking into account the specificities of the various types of financial instruments and where applicable their registration with a central depositary, including but not limited to:**

    - **the conditions upon which such financial instruments shall be registered in a financial instruments accounts opened in the depositary's books opened in the name of the AIF or, as the case may be, the AIFM acting on behalf of the AIF,;**

    - **the conditions upon which such financial instruments shall be deemed (i) to be appropriately segregated in accordance with the principles set forth in Article 16 of Commission Directive 2006/73/EC9), and (ii) to be clearly identified at all times as belonging to the AIF, in accordance with the applicable law; and what shall be considered as the applicable law.**

One respondent was of the view that the list of financial instruments should not by default include all instruments listed in Annex 1 of MiFID, and that it would in any case be difficult to develop a durable and exhaustive list of criteria to determine in which of the two categories an asset should fall. However, it did suggest the following non-exhaustive criteria:

- whether the interest is a proprietary right or merely a right under contract

- whether the instrument is freely transferable;

- whether the instrument is fully fungible with all other instruments of the same class;

- whether the instrument carries with it special obligations attributable to the holder; and

- whether, in the case of proprietary rights, the interest is evidenced by a certificate or by an entry on an appropriate register.

Applying these criteria would, in its view, generally exclude OTC derivatives and interests (shares or units) in partnerships or funds not traded on a regulated market. The depositary would be able to record such interests for its own record-keeping purposes.

Two respondents identified the following financial instruments: transferable securities, units in collective investment undertakings and money market instruments while one stakeholder identified bonds, fund units and units of CIS registered with the depositary itself or the CSD. Two respondents considered that all remaining assets in the list of financial instruments in MiFID should be treated as 'other assets' while one specifically referred to cash, real estate, commodities, loan funds, private equity and derivatives.

For one respondent, financial instruments that can be physically delivered to the depositary should include instruments in certificated form e.g. stock certificates, treasury bonds.

One stakeholder proposed the following definition of assets 'held in custody': all the assets that can be registered in an account open in the name of the custodian (for example a nominee account) on behalf of clients (hence the necessity of segregating the accounts), which includes the cash. The respondent was of the view that depositaries should all register in their books the same types of assets, regardless of the Member State where they are located, in order to ensure that the obligations attached to these instruments are harmonised throughout the EU. The same respondent felt that the obligation to return the assets should apply to any AIF asset and registered in the depositary's name as well as to any asset held in custody by the depositary. Finally, it suggested that regarding segregation of assets, the same approach proposed for the segregation of cash should be applied more generally to all assets held by the sub-custodian, i.e. assets should be segregated in 3 accounts, namely: own assets, investment funds (i.e. AIFs and UCITS, i.e. assets managed on behalf of third clients) and other clients' assets.

One contributor favoured limiting financial instruments that can be held in custody to securities which:

- are dematerialised in a way which means that they can only effectively be held in a securities account (i.e. not simply dematerialised via the ownership being recorded on the register kept by the company or its registrar);

- are liquid, traded securities which are fully fungible, with no special obligations attaching to the holder and no restrictions on transfer.

The same respondent also highlighted that on the basis of Art. 21(15(c), financial instruments issued in a nominative form and registered with an issuer or depositary should not be held in custody. In its view, the only financial instruments that can be physically delivered are bearer investments where title is held by whoever holds the relevant certificate of title.

Finally, one respondent saw the following as the types of financial instrument that can easily be registered in a financial instruments account opened in the name if the AIF: standard equity securities, bonds (corporate, government/municipal, etc.), underlying fund interests, exchange-traded funds and exchange-traded notes

and money market instruments. The same respondent noted that there was an overlap to some extent between these instruments and those that can be physically delivered to the depositary.

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

- the type of 'other assets' with respect to which the depositary shall exercise its safekeeping duties pursuant to paragraph 7(b), namely all assets that cannot or are not to be kept in custody by the depositary pursuant paragraph to Article 7(a);

- the conditions applicable to the depositary when exercising its safekeeping duties over

such 'other assets', taking into account the specificities of the various types of asset,

including but not limited to financial instruments issued in a 'nominative' form, financial instruments registered with an issuer or a registrar, other financial instruments and other types of assets.

One respondent was of the view that 'other assets' should be defined as any asset belonging to the AIF that does not fall within the scope of instruments that can be held in custody within the meaning of Art. 21(7)(a) e.g. real estate, commodities, OTC derivatives, while stressing that any list of such assets should be non-exhaustive. The same respondent also disagreed with the assumption that financial instruments registered with an issuer or a registrar should automatically fall within the scope of 'other assets'; they gave the example of units in CIUs which are often registered with a registrar but are also capable of being registered in a financial instruments account opened in the depositary's book.

One stakeholder called on ESMA to clarify that where a depositary holds position records in 'other assets', those records did not amount to the holding of assets in custody and should therefore not give rise to any liability for the loss of assets (except for when there was a failure on the part of the depositary to take appropriate steps to verify ownership of the assets). The same stakeholder also noted that the depositary would often not have a record of such assets because it would not typically have been involved in the settlement process.

It was also suggested that the starting point should be the operational standards set out in Article 18 of the MiFID implementing Directive, subject to appropriate adaptation.

Two respondents were of the view that holdings in securities issued by private companies should be treated as 'other assets'. One of them explained that in the UK, share certificates are prima facie evidence of title only, the register of members being the primary record.

Finally, one contributor identified derivative instruments, bank loan debt, contractual rights to income streams (e.g. rights to income derived from intellectual property rights), life settlement policies, private equity interests and direct real estate interests as assets for which a depositary may be asked to exercise its safekeeping duties. The same respondent was in favour of the development of a list of 'other assets' at Level 2 but preferred the conditions for the exercise of the duty to be addressed via guidelines in order to accommodate the wide range of instruments, legal and regulatory considerations and business models of depositaries and managers.

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

- **the conditions upon which the depositary shall verify the ownership of the AIF or the AIFM on behalf of the AIF of such assets;**

- **the information, documents and evidence upon which a depositary may rely in order to be satisfied that the AIF or the AIFM on behalf of the AIF holds the ownership of such assets, and the means by which such information shall be made available to the depository;**

- **the conditions upon which the depositary shall maintain a record of these assets, including but not limited to the type of information to be recorded according to the various specificities of these assets; and the conditions upon which such records shall be kept updated.**

One respondent felt that ESMA should follow a flexible approach regarding the ownership of assets which can apply across all relevant asset classes, having regard to the nature and type of evidence which is available to the depositary. The same respondent also believed that ESMA should consider giving specific guidance in relation to certain asset classes where the depositary may have no or limited means to access evidence of title. Also should recognise that the AIFM may (e.g. in the case of real estate funds) acquire property on the basis of a number of factors including impaired legal title where evidence of title is more a matter for the AIFM than the depositary. 'Ownership' should not, therefore, be regarded as full and unencumbered title.

Two respondents considered it vital that the Level 2 measures provide depositaries with sufficient legal and operational certainty in respect of verification of ownership. One them was in favour of having clear principles at Level 2 (on the form of acceptable record-keeping, the required frequency of updating records etc.) and practical examples at level 3 of information, documents and evidence on which the depositary may rely for each asset class.

One respondent felt that, while the depositary should be able to re-use collateral, the legal ownership to the relevant financial instruments should not be transferred to it unless this is specified in the collateral agreement.

It was also suggested that in the absence of title in the form of a certificate, the depositary could receive a report from the lawyer or adviser who worked on the private equity or venture capital transaction which shows the resulting ownership position following the transaction. Similarly, it was considered sufficient for the depositary to receive copies or evidence of entries on share registers and that additional checking should only be required in rare cases.

Finally, one respondent felt the depositary would have to rely on the agreements, confirmation and original documents issued by the counterparty/entity holding the register.

Question 4: In its advice, CESR should also consider the circumstances where assets belonging to the AIF, are subject to temporary lending or repurchase arrangements or any type of arrangements under which financial instruments may be re-used or provided as collateral by the AIF or AIFM on behalf of the AIF, whether or not such arrangements involve transfer of legal title to the financial instruments, and advise on the conditions applicable to the depositary to perform its safekeeping duties accordingly.

One respondent was of the view that assets that have been disposed of either in whole or in part and as a result are no longer 'entrusted' to the depositary (such as assets that are the subject of securities loans, repos or other collateral arrangements) should be excluded from the scope of a depositary's safekeeping duties. Similarly, one respondent felt that assets rehypothecated by the prime broker were not the responsibility of the depositary.

One stakeholder provided a detailed description of market practice in this area in the areas of stock lending and repo, derivatives transactions and rehypothecation of assets by the AIFM's prime broker. In general, this stakeholder was of the view that all counterparty trading arrangements under which assets of the fund have been delivered as collateral should be excluded from the depositary's liability, subject to a duty of the depositary to oversee the adequacy of arrangements put in place by the AIFM in respect of the assets of the AIF that are delivered as collateral to such counterparties.

It was also explained that it was rare for private equity and venture capital AIF to engage in such practices, except for situations where the funds are invested in highly-liquid instruments ready for draw down or on an IPO where the private equity or venture capital owner may make securities available on a loan basis to those responsible for stabilising the issue.

Finally one stakeholder favoured requiring the prior consent of the depositary in the case of temporary lending or repurchase arrangements.

Issue 13.3 – Depositary functions pursuant to paragraph 8

Question 1: CESR is requested to advise the Commission on the conditions the depositary must comply with in order to fulfil its duties pursuant to Article 21(8). The advice shall include all necessary elements specifying the depositary control duties when inter alia verifying the compliance of instructions of the AIFM with the applicable national law or the AIF rules or instruments of incorporation, or when ensuring 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 laid down in Article 19.

One respondent stated that proper performance of these duties of the depositary was dependent on the AIFM providing up-to-date versions of the rules and/or instruments of incorporation of the AIF. The same respondent reiterated its view that the obligations of the depositary should be those of oversight and checking of appropriate processes rather than double-checking every single event.

It was also recalled that depositary performed its control duties only ex post, at a second level, after the AIF has carried out its own duties.

One contributor considered that it should not be necessary for the depositary to undertake significant work to fulfil these requirements and that it should be able to rely on the work done by other parties (e.g. by reviewing audited financial statements of the AIF).

One respondent was of the view that the depositary should not be required to conduct extensive, independent investigations and its role should be limited to: i) receiving copies of audit checks on valuation procedures; and ii) requiring the AIFM to produce reasonable evidence of compliance in cases where it has sufficient groups to believe that the AIFM's instructions are contrary to law or the AIF's fund rules.

Finally it was suggested that the verification for point (a) could be done via a periodic verification of samples; for point (b) via a comparison between the NAV versus a benchmark; while point (c) would be more of an on-going obligation. It was also put forward that it should be possible for the depositary to inform the AIFM of failures and to correct them, and that the competent authority should be informed in the case of significant failures.

Issue 14 – Due diligence

Question 1: CESR is requested to advise the Commission on the duties the depositary has to carry out in exercising its due diligence duties pursuant to Article 21(10), namely:

- **procedures for the selection and the appointment of any third party to whom it wants to delegate parts of its tasks; and**

- **procedures for the periodic review and on-going monitoring of that third party and of the arrangements of that third party in respect of the matters delegated to it.**

One respondent felt that as a general rule, if a depositary has undertaken sufficient due diligence in respect of a 3rd party in order to satisfy its obligations under Art. 21(10)(d), that due diligence should also be sufficient for the purposes of Art. 21(10)(c). The same respondent also called for consistency with other international standards and EU legislation in other areas, such as MiFID (particularly Chapter II, Section 3 of the implementing Directive).

Similarly, this stakeholder saw Articles 14 (also EFAMA) to 17 of the MiFID L2 Directive as the starting point, subject to appropriate adaptation and was also of the view that in determining whether its due diligence obligations have been satisfied, a depositary should be able to take into account any specific instruction or demand by the AIF or AIFM that the depositary appoint or place financial instruments with that 3rd party.

One stakeholder also identified the following as elements to be considered:

- Financial strength
- Market reputation
- Management and the operational infrastructure assessment
- Understanding and accountability for compliance with regulatory policies
- Staffing and expertise of the custody operation
- Contingency / business continuity plans
- Internal control and related risk management infrastructure
- Results of external/internal audits

- SAS70/FRAG 21 or equivalent third party review of the custody operation
- Insurance coverage
- Vault capacity and security (in markets where physical certificates are held)
- Information on external linkages to settlement and registration processes, depositories, exchanges and clearing entities
- The provision of effective access to data related to the third party's custodial activities, as well as to the business premises of the third party to the depositary, its auditors and the relevant competent authorities, and the ability of the competent authorities to exercise those rights of access
- Information on income processing, corporate actions and proxy voting services and capabilities
- Contractual arrangements
- Consideration of any other operational, legal and regulatory risk that may adversely impact the AIF's rights

One stakeholder supported the introduction of a duly-documented procedure for selection of the sub-custodian, taking into account the solidity of the delegatee and allowing the custodian to demonstrate the qualifications and capability of the delegatee. The same respondent was of the view the auditor's report should specify that the depositary has complied with these provisions.

One respondent identified what it saw as the three key elements in the appointment of a third party:

i) Initial due diligence on the record-keeping and competence of the delegate and its system for ensuring segregation of assets.

ii) Ensuring that the sub-custodian is subject either by contract or otherwise to the segregation, use and other general obligations and prohibitions referred to in Art. 21(10)(d).

iii) Annual reporting by the delegate and, where appropriate, updating of due diligence.

One association listed the following as key due diligence standards: conducting an analysis of custody risks associated with the placement of assets with a sub-custodian entity; monitoring the custody risks associated with the maintenance of assets with a sub-custodian entity on a continuous basis and promptly notifying the fund or AIFM of any material change in these risks; ensuring that the sub-custodian exercises reasonable care, prudence and diligence in the performance of its

safekeeping duties; and withdrawing assets from the sub-custodian as soon as reasonably practicable if the sub-custodian no longer meets the requirements of the Directive.

The following elements were also identified as being key in the due diligence: solvency, credit rating, legal and operational risk profile. It was suggested that such information could be extracted from the potential sub-custodian's SAS 70 certification.

Question 2: CESR is encouraged to develop a comprehensive template of evaluation, selection, review and monitoring criteria to be considered by the depositary while exercising its due diligence duties under Article 21(10).

Two respondents were of the view that it would not be practicable to develop a list of criteria to be considered by every depositary in every delegation scenario, given the range of circumstances in which a depositary might seek to delegate. They also believed that any such list would have to i) be non-exhaustive; ii) recognise that some criteria may be less relevant than others in a particular case; and iii) recognise that some criteria may not be relevant at all in a particular case. It was proposed the following as factors that may be relevant:

- whether, to what extent and by whom the third party is regulated;
- the depositary's experience (if any) of the third party's performance of services to the depositary;
- the arrangements which are or will be made by the third party for the holding of assets;
- the expertise and market reputation of the third party;
- in the case of assets held by a third party in a 'third country', relevant legal requirements or market practices regarding the use of particular sub-depositaries;
- the extent to which assets held by the third party will subject to reasonable care, based on the standards applicable to depositaries in the relevant market, after considering all relevant factors including (to the extent applicable or relevant):
    - the third party's practices, procedures and internal controls relevant to the tasks being delegated;
    - whether the third party has the requisite financial strength to provide reasonable care for assets;
    - the third party's general reputation and standing; and

- whether the depositary (or the AIF, where relevant) will have jurisdiction over and be able to enforce judgments against the third party (such as by virtue of relevant offices or consent to service of process); and

- whether the AIF or the AIFM has specifically requested or demanded that the depositary appoint or place financial instruments with that third party.

Issue 15 – The segregation obligation

Question 1: CESR is requested to advise the Commission on criteria to be satisfied to comply with the segregation obligation whereby the depositary shall ensure on an on-going basis that the third party fulfils the conditions referred to in Article 21(10)(d)(iv).

One respondent explained that in its view, the segregation obligation would allow sub-custodians to hold the depositary's client assets in pooled omnibus accounts, in line with general practice (provided that the same account does not hold the sub-custodian's own assets). The same respondent also understood the segregation requirement as applying at the level of the sub-custodian's own books and records, not at the level of accounts held by the sub-custodian with third parties e.g. a CSD.

On a similar note, two stakeholders stressed that the advice on segregation needed to take account of the legal and operational realities of the way in which assets are currently held in the international custodial system and the cost implications of any changes. They added that full segregation on a client-by-client basis throughout the custody chain would be impossible to achieve in practice.

One contributor believed that segregation should be applied in the accountancy of the custodian and of each of its delegates and sub-delegates. The same respondent felt that where the depositary delegates the custody of the assets to a third party, such delegation should be explicitly disclosed to investors.

One respondent stated that it is possible for private equity and venture capital investments to be segregated by registration in the name of the AIF concerned or in the name of a nominee which only holds client assets.

Finally, one stakeholder noted that there may be limitations on segregation in some less developed markets i.e. segregation at sub-custodian level may not be permitted by local law. The same respondent also highlighted that segregation of cash was not typically possible.

Issue 16 – Loss of financial instruments

Question 1: CESR is requested to advise the Commission on the conditions and circumstances under which financial instruments held in custody pursuant paragraph 7(a) shall be considered as 'lost' according to Article 21(11). In its advice, CESR should take into account the various legal rights attached to the financial instruments depending, for example, on the legal concepts ('ius ad rem' vs. 'ius in personam') used in the jurisdiction where they have been issued and any legal restrictions applicable to the place where they are kept in (sub-) custody.

One stakeholder felt that 'lost' should be defined as meaning 'irretrievably and permanently lost without any prospect of being able to recover or realise the financial instruments in question'. This would not cover situations where the assets are unavailable or temporarily frozen. In its view, defining 'lost' more broadly could increase systemic risk by dissuading a number of entities from acting as depositaries, thereby concentrating risk among a smaller number of counterparties, as well as pushing up custodial fees.

One respondent favoured a harmonised obligation on depositaries to return lost assets except when the three cumulative criteria of the force majeure have been satisfied, on the basis that this would increase investor protection. This respondent was of the view that the AIFMD already indirectly included two of the three force majeure criteria and that it only remained for the L2 text to confirm that 'unpredictability' should also be introduced.

It was also suggested three criteria for determining whether an asset was lost: i) it is no longer held for the account of the AIF; ii) it is no longer held by the AIF; iii) it is no longer held by the custodian.

Finally, for one contributor, it was important that the advice be aligned with the future Securities Law Directive.

Question 2: In its advice, CESR should specify circumstances when such financial instrument should be considered permanently 'lost', to be distinguished from circumstances when such financial instruments should be considered temporarily 'unavailable' (held up or frozen).

To that end, CESR shall consider inter alia the following circumstances:

- **Insolvency of, and other administrative proceedings against, a sub-custodian;**
- **Legal or political changes in the country where financial instruments are held in sub custody;**
- **Actions of authorities imposing restrictions on securities markets;**
- **Risks involved through the use of settlement systems; and**
- **Any other circumstances which may prevent the AIF from using or disposing of its assets that are kept in custody by a depositary or a sub custodian.**

One respondent considered that the following situations should not, in themselves, constitute financial instruments being lost:

- insolvency of, and other administrative proceedings against, a sub-custodian (also IFIA);
- risks involved through the use of settlement systems; and
- any other circumstances which may prevent the AIF from using or disposing of its assets that are kept in custody by a depositary or a sub custodian.

In contrast, the same respondent felt that the following situations may, depending on the circumstances, result in financial instruments being lost:

- legal or political changes in the country where financial instruments are held in sub custody; and
- actions of authorities imposing restrictions on securities markets.

This stakeholder would view the above-mentioned circumstances as being external events beyond the depositary's reasonable control.

Finally, one respondent was of the view that none of the following situations should be understood as a loss: loss of value of the assets concerned, insolvency of the investee company or restructuring of a company or investments such that certain investments are cancelled in exchange for others or change their nature.

Issue 17 – External events beyond reasonable control

Question 1: CESR is requested to advise the Commission on conditions and circumstances for events to be considered as:

- **external,**
- **going beyond reasonable control, and**
- **having consequences which would have been unavoidable despite all reasonable efforts to the contrary.**

The following definitions were proposed by a respondent to the call for evidence:

External Event – should mean any event not taken directly by, or caused directly by, the actions of the depositary.

Beyond a depositary's reasonable control – should mean an event which has not been caused by a depositary's failure to carry out a duty which it reasonably could have been expected to take.

Having consequences which would have been unavoidable despite all reasonable efforts to the contrary – should mean any event or result which could not reasonably have been foreseen or could not reasonably have been avoided. What constitutes 'all reasonable efforts' should be determined under the national law of the jurisdiction in which the depositary is domiciled.

Question 2: If possible, CESR is requested to advise the Commission on a non-exhaustive list of events where the loss of assets can be considered to be a result of an external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary. CESR is encouraged to consider the appropriate form (e.g. guidelines) of such a list.

The following non-exhaustive list was proposed by one respondent:

- Any loss of financial instruments which results from (i) the general risk of investing, or (ii) investing or holding financial instruments in a particular country, including, but not limited to, losses resulting from any event beyond the reasonable control of the depositary or its agents or sub-custodians, including, but not limited to, nationalization, strikes, expropriation or other government actions, devaluations or fluctuations, seizure, 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; or the breakdown, failure, malfunction, error or interruption in the transmission of information caused by any machines, utilities or telecommunications systems; or any order or regulation of any banking or securities industry 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; or any other similar or third-party event; or acts of war, terrorism, insurrection or revolution; or acts of God.

- Any loss of financial instruments resulting from the actions or omissions (including but not limited to any fraudulent or negligent activities or omissions) of a third party (including any sub-custodian, prime broker, OTC derivative counterparty, third party financing provider) which holds such financial instruments, provided that such loss could not have been avoided by the depositary taking reasonable care in the exercise of its functions.

- Any loss of financial instruments which are held by a third party (including any sub-custodian, prime broker, OTC derivative counterparty, third party financing provider) which the AIF has instructed or demanded that the depositary appoint or place financial instruments with.

The following examples were also given by one stakeholder:

- force majeure – (e.g., act of God, explosion, fire, accident, lightning, outbreak of war, armed conflict,

- act of any government of authority, power failure, failure of telecommunications lines,);

- failure of settlement system, central securities depositary or exchange;
- terms or conditions imposed by post-market infrastructure (including both Central Securities Depositaries ('CSD') and payment systems);
- risk resulting from investment decisions taken by the AIFM;
- default, insolvency of any counterparty or broker;
- fraud committed by an employee of any counterparty, broker, sub-custodian, settlement system,
- registrar, issuer or other third party;
- use of a prime broker which has been appointed by the AIFM;
- securities holdings recorded by an agent of the issuer, such as a transfer agent or registrar;
- certain market conditions or events, including currency restrictions, sovereign default and the
- expropriation of assets; and
- any factor which is internal to the third party's organisation.

Issue 18 – Objective reason to contract a discharge

Question 1: CESR is requested to advise the Commission on the conditions and circumstances under which there is an objective reason for the depositary to contract a discharge pursuant to Article 21(12).

For one stakeholder an objective reason should exist whenever:

(i) the requirements set out in Article 21(10)(a) to (d) are satisfied (to the extent required by paragraph 10); and

(ii) the loss does not otherwise directly result from the acts or omissions of the depositary.

The same respondent noted that the event giving rise to the objective reason may only arise at a later stage so it should be possible to anticipate such events at the moment when the contract is signed. This respondent also felt this did not constitute a 'light-touch' approach in the sense that the depositary would need to have exercised all due skill, care and diligence in selecting and monitoring the relevant third party (as well as not being at fault for the loss) in order to discharge liability.

One respondent favoured restricting the cases for exemption of liability as much as possible and recalling that the depositary should act in the best interests of investors at all times, as well as the specific obligations that arise in the case of delegation. However, this stakeholder was of the view that the implementing measures should not be more detailed than the UCITS Directive, taking into account the generally professional nature of AIF investors.

One respondent felt that wherever there is a good, practical reason for delegating safekeeping functions (e.g. location, jurisdiction, specialist asset class, expertise of the delegate), that objective reason for delegation should be considered an objective reason to contract a discharge. IFIA took a similar view, suggesting that market efficiency should be a valid reason and calling on ESMA to take full account of current market practice.

Question 2: In its advice, CESR is encouraged to provide an indicative list of scenarios that are to be considered as being objective reasons for the contractual discharge referred to in Article 21 (12).

One respondent provided the following examples:

(a) the loss results from:

- the negligence or wilful default of the third party;

- the fraud of the third party;

- the material breach of an applicable regulatory requirement, or the committing of an offence under applicable law, by the third party;

- the insolvency of the third party; or

(b) the AIF or the AIFM has specifically instructed or demanded that the depositary appoint or place financial instruments with the third party.

The following list was also proposed by one respondent:

- where the AIF or AIFM has directed the Depositary to appoint a particular third party (including pursuant to prime brokerage and securities lending arrangements);

- where access to a particular market is only possible through the appointment of a third party and the AIF or AIFM requires access to such a market and accepts any risk arising; and

- where it is in the interests of the AIF for reasons of market efficiency to appoint a third party.

Part III: Transparency requirements and leverage

Issue 19 – Article 4, Definition of leverage

General comments

One respondent noted that it was crucial to take account of the different AIF strategies and the different types of leverage employed when applying a definition. The same respondent gave the example of a managed futures strategy, for which the leverage should in their view be defined as the absolute sum of contract sizes of all future positions divided by the fund's NAV; for long-short strategies, on the other hand, they felt that leverage should reflect the absolute sum of market values of all (long and short) assets divided by the NAV of the AIF. BVI felt that for AIF running UCITS-like strategies, a leverage definition based on VaR should be possible. There should also be flexibility for AIF investing in other kinds of asset or employing different strategies. Finally, this stakeholder also considered that the disclosure requirements on leverage set out in CESR's guidelines on risk measurement and the calculation of global exposure and counterparty risk for UCITS (Ref. CESR/10-788, Boxes 24 and 25) should be applicable for reasons of consistency.

One stakeholder called for flexibility in the definition of leverage and stressed that disclosure was the key aspect from the professional investor's perspective.

One respondent to the call for evidence considered it crucial that the definition of leverage not include loans to the fund made by investors as part of their commitment to the fund, noting that although such loans technically increased the fund's exposure, they do not constitute borrowing. Similarly, this respondent explained that many unleveraged funds 'bridge' funding calls (drawdowns) by taking out short-term borrowings with a bank in order to complete investments quickly and avoid the need for numerous, small draw downs and felt that such arrangements should not be considered as leverage. Finally, this stakeholder stressed the need to avoid any provisions which called into question the exclusion of borrowing at the level of a portfolio company at L1 (Recital 14 and Art. 4(w)).

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

One respondent provided a list of methods by which AIFM can increase exposure of the AIF they manage, such as via cash prime brokerage through financing, repo and loan agreements. However, they considered that given the wide range of derivatives that can embed leverage, it would not be appropriate to prescribe a list of specific methods and that the description of leverage should be left generic and broad, with only a few illustrative examples. Another stakeholder identified the use of mortgages and derivatives as two methods by which UCITS can increase their exposure.

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

Some respondents saw merit in allowing AIFM to adopt similar methods to those methodologies already in use in the UCITS sector, as set out in CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS, July 2010. However, two respondents were in favour of allowing a wide range of methodologies to be used, with standard models proposed for the measurement of risk and leverage with alternative, appropriate methodologies, which are not fully described in either legislation or guidance, also being permitted. Other respondents highlighted that the methodology proposed by CESR for the calculation for UCITS had been criticised by many respondents to the consultation that the approach subsequently adopted did not provide investors with a meaningful indicator of leverage. These members considered that the sum of notionals would not be a meaningful risk measure except for the most simple of AIF.

One respondent also noted that the UCITS Guidelines included references to OTC Counterparty Risk Exposures and explained that several of the recommendations (Box 26 and Box 27) in relation to collateral management could not be applied to AIF. They gave the example of the notion of holding ISDA collateral at a third party custodian, which was not common practice in the hedge fund industry, as well as the requirements of not allowing third parties to reuse non-cash collateral, which in their view could greatly enhance the cost of financing. Finally, this respondent stressed that it would be impossible under the single depositary rules to apply the counterparty diversification discussed in Box 27.

Ultimately, one stakeholder recalled that the leverage at the level of the target company should not be taken into account in the case of private equity and real estate funds (in line with Recital 14 of the Directive). The same respondent was of the view that in the case of securities issued by companies, the leverage inside those companies should not be taken into account.

Issue 20 – Article 20, Annual report

General comments

One respondent called for ESMA to take into account the existing rules at national level. Specific reference was made to German rules on fund accounting adopted by BaFin in late 2009.

Two stakeholders stressed that the presentation and content of financial statements was a matter to be governed by accounting standards and that it should be clear that any additional content was not part of the financial statements.

Several respondents asked ESMA to take account of the requirements of the UCITS Directive. One respondent also felt that the framework under the AIFMD should be sufficiently flexible so as not to constitute a de facto barrier to entry for non-EU AIF once the passport was introduced.

Question 1: CESR is requested to advise the Commission on the content and format of the annual report. In its advice, CESR should consider whether all or any of the information referred to in Article 23 should be included in the annual report and the need for appropriate explanatory notes.

One respondent made the following proposals for the content of the annual report based on the assumption that the advice would relate to the annual report of the AIFM:

- Audited financial statements presented in accordance with US GAAP or IFRS or equivalents.

- Directors' Statement and Report. The Statement will conclude that the financial statements have been presented fairly. The Report will present the performance of the fund for the period and any other significant events as required to be disclosed under Article 22, particularly with regards to the e) and f) – refer question 6 below and Article 23 – refer to question 4 below.

- Any local statutory requirements

The same respondent considered that this should suffice in terms of disclosure in the annual report on the basis that investors in AIF are capable of carrying out their own due diligence.

One other stakeholder saw merit in aligning the requirements with the UCITS Directive as much as possible. The same respondent considered that all significant holdings of illiquid assets (>1%) should be disclosed separately with details of whether they have been segregated in a side pocket and the nature of its illiquidity and the length of time needed for potential liquidation.

One respondent to call for evidence highlighted the need to take into account the different disclosures that are needed for hedge funds, real estate funds and private equity funds

One stakeholder explained that in a UK context, many private equity and venture capital funds draft the accounting policies in their limited partnership agreements in line with recognised accounting standards (e.g. UK GAAP or IFRS) but often with specific provisions deviating from those recognised standards. The same stakeholder considered that this flexibility should be allowed to continue, in order to allow the information to be tailored to the needs of the investors.

One respondent made a number of points. It first highlighted the importance of ensuring that commercially sensitive information is not disseminated in a way that would be detrimental to the performance of the fund. Also it went on to stress that information provided to investors (e.g. on valuation of assets) may go considerably beyond that required to be presented in the statutory accounts of the underlying investments, and that it would be inappropriate to require AIFM to provide the same information to CAs and investors. The same respondent sought clarification on what it saw as a potentially conflicting requirement to prepare the fund's accounts in accordance with the accounting standards of the home member state of the AIF and the accounting rules laid down in the fund rules. In this context, the respondent went on to stress that PE and VC funds should be exempt from any requirement to prepare consolidated accounts (in line with US GAAP).

Question 2: CESR is requested to advise the Commission on the content and the format of a balance sheet or a statement of assets and liabilities. In its advice, CESR should specify in particular:

- **the appropriate presentation, elements and level of detail of the AIF's assets;**
- **the appropriate presentation, elements and level of detail of the AIF's liabilities;**
- **the appropriate presentation, the elements and level of detail of net assets (shareholders' or unitholders' equity); and**
- **the statement of cash inflows to and outflows from the AIF.**

One respondent felt that format of the financial statements should be aligned with IFRS or US GAAP or an equivalent. Similarly, another contributor was against the development of prescriptive rules on the format or content of the financial statements taking into account the wide range of entities covered by the Directive; in their view it was more appropriate to apply the relevant GAAP or specific legislation at the level of the AIF.

Several respondents suggest that the elements and level of details for the assets, liabilities, net assets (shareholders' equity) and cash inflows and outflows that should be included in the AIF annual report should include all significant assets and liabilities as separate line items.

If it were considered necessary to adopt a minimum standard, one felt it would be sufficient to specify that the annual accounts must include a statement of investments containing enough information for the investor to make an informed judgement of the developments of the AIF's activities.

Question 3: CESR is requested to advise the Commission on the content and format of an income and expenditure account for the financial year. In its advice, CESR should specify in particular the elements and the level of detail of AIF's income and expenditure accounts.

Two respondents made the same points as under Q2 above.

Question 4: CESR is requested to advise the Commission on the content and format of the report on the activities of the financial year. In its advice, CESR should consider specifying inter alia:

- **statement explaining how the fund has invested its assets during the relevant period in accordance with its published investment policy;**

- **overview of the AIF's portfolio and, where appropriate, the AIF's major investments;**

- **financial results; and**

- **directors' and corporate governance report depending on the legal structure of the AIF.**

One respondent felt that the opportunity for Directors to elaborate on the fund's activities for the financial year should be voluntary. The same respondent identified the following additional information that could be included on a voluntary basis:

activities in the year- a fair review of events in the year including, in particular changes in key risks and significant events in the year (including liquidity issues such as the introduction of gates or side pockets or side letters);

- developments after the year end - as above since balance sheet date, taken up to date of issue of the financial statements;

- results and dividends;

- listing of officers and directors of fund;

- include calculation of 1, 3 and 5 year investment return for the fund or the principal series (NB disclose performance of side pockets separately) together with basis of computation.

One stakeholder said that the annual report should include a disclosure explaining the types of investment that the fund is allowed to make during the year in accordance with its investment policy, and the purpose and risks associated with each investment type. A schedule of investments should be included in the

financial statements which summarises the types of investments held, at fair value. Any significant investments (usually over 5-10%) should be disclosed as a

separate line item, at fair value. Financial results should be disclosed in the financial statement to provide investors with objective data regarding the results of the AIF's operations and significant ratios as a measure to compare them with the results of other AIF. In general, the financial results should include share information, total return, and expense ratios. The same respondent noted that information in the directors and corporate governance report is usually unaudited but that it could prove useful to investors and that regardless of the directors' and governance report, the legal structure of the fund should be disclosed in the footnotes of the financial statements.

Finally, one respondent felt that the additional disclosures should be limited to:

i) a short description of the new investments made during the year;

ii) a table presenting the AIF's portfolio with a few short comments on the development of the activities of the most significant investments;

iii) a short description of the most significant exits/sales during the period; and

iv) a short description of the fund's financial performance using existing recognised fund performance measures.

Question 5: CESR is requested to advise the Commission on how material changes in the information listed in Article 23 during the financial year covered by the report should be best presented in the annual report.

For this question, please see the responses to the question 4 above.

Question 6: CESR is requested to advise the Commission on the content and the format of the remuneration disclosure required under points (e) and (f) of Article 22(2) including the details on the form of remuneration.

One respondent was of the view that it would be inappropriate to include remuneration disclosure in the AIF's annual report as it would suggest (misleadingly) that i) the fund has control over the remuneration of the AIFM and how it is split between staff at the AIFM; ii) the remuneration is linked to the performance of the AIF when in fact it would be linked to the performance of a number of funds managed by the AIFM; and iii) the remuneration is for the period of the AIF's annual report, when in most cases it will reflect a different period.

One contributor called for the guidelines on remuneration disclosure to take full account of the nature, scope and complexity of the AIFM.

One stakeholder was of the view that a breakdown between fixed and variable remuneration paid by the AIFM to its staff was not relevant given that staff salaries were not paid by the AIF. However, this respondent did see merit in disclosing the management and performance fees paid to the AIFM.

It was the interpretation of one respondent that 'senior management and members of staff of the AIFM whose actions have a material impact on the risk profile of the AIF' should be understood as a single category and that one aggregated number would be sufficient. This respondent felt the advice should clarify the criteria for identifying which staff members should be covered, while noting that this could be postponed pending the development of guidelines on remuneration more generally. This stakeholder also stressed that disclosure of carried interest should be of an aggregated amount showing the total amount paid by the AIF to the AIFM during the period in question. The same respondent considered that disclosure on anything other than an aggregated basis would be much stricter than the disclosure requirements on listed and non-listed entities in some jurisdictions. Finally, this respondent felt there should be specific rules for entities with a very small number of employees in a particular category, in order to avoid a situation in which an individual's remuneration could be disclosed indirectly.

Issue 21 – Article 23, Disclosure to investors

One respondent considered that it would be difficult to develop universally applicable criteria for assessing liquidity of assets on the basis that liquidity depended on many interrelated factors. Regarding frequency of disclosure (both on liquidity and leverage), the same respondent felt that once per annum would be sufficient and that AIF with only professional investors should be able to agree the frequency of reporting requirements on a case-by-case basis.

One stakeholder made a number of general points. On frequency of reporting, the respondent felt that disclosure should be triggered when something material changes relative to previously made disclosure. They also felt that the rules should not be too prescriptive as appropriate disclosures will vary widely among different types of AIFM, depending on strategies, asset classes and fund types. In their view it was not necessary to prescribe a format as the wide differences between different types of funds will make a prescriptive format unworkable. Finally, one respondent cautioned against the adoption of rules based on the UCITS framework in this area.

A number of detailed points were made by one stakeholder in the context of assets subject to special arrangements, new arrangements for managing liquidity and risk profile and risk management.

One contributor questioned the need for AIFs that routinely and consistently employ higher levels of leverage to make disclosures more regularly than on an annual basis.

One respondent recalled the professional nature of many AIF investors which would tend to support a lower level of predetermined detail and greater flexibility, taking into account in particular that MS may impose additional requirements for sales to retail investors. The same stakeholder also highlighted that many closed-end AIF were subject to the PD and reporting requirements of the relevant listing authorities.

One respondent felt that where it has been made clear from the outset that the AIF invests in illiquid assets and investors have been made aware of the potential impact, this should be reflected in the frequency of the disclosure. On leverage, the same respondent suggested that ESMA should provide some standard methodologies such as gross leverage, net leverage and ex-post volatility to allow for easy comparison of different AIF by investors.

One stakeholder felt that the risk profile of the manager should be provided only according to the strategies followed by the manager.

One respondent requested that the advice clarify that in the case of funds without redemption rights and which invest in illiquid assets, an initial disclosure of that business model should suffice and that the periodic disclosure requirements in Art. 23(4) would not apply.

Issue 22 – Article 24, Reporting obligations to competent authorities

General comments

One stakeholder requested that the requirements be sufficiently flexible to deal with the full range of types of AIFs, including the breadth of investor base and frequency of dealing in AIF units or shares.

One contributor saw no particular value in leverage as a measurement per se and felt it was more relevant to take into account the liquidity of the assets on which the leverage is applied. They gave an example of leverage of 10/15x in a futures portfolio, which they considered not to be a problem given the high liquidity of the futures market, compared with leverage of 2x of a portfolio of distressed debt which raised greater concerns.

Question 1: CESR is requested to advise the Commission for the purposes of paragraph 4 on the criteria to be used to determine under which conditions leverage is to be considered as being 'employed on a substantial basis'.

One respondent proposed that for AIFSs investing in financial instruments, substantial leverage should be interpreted as leverage above the cumulated level of temporary borrowing and leverage achieved through derivatives under the UCITS Directive (>110%), taking into account that UCITS are designed as retail products. For AIFs investing in real estate, two respondents called for recognition of the fact that in most cases of borrowing only specific properties were treated as collateral (e.g. by means of land charge or mortgage agreement) and no recourse to the fund per se was possible; given this limitation to the risk of loss, these respondents felt that the threshold for substantial leverage should be set appropriately high.

One stakeholder noted the difficulty of determining when leverage is being employed on a substantial basis and called for the wider context to be taken into account i.e. liquidity of the underlying instruments, sources of leverage, strategy of the AIFs etc. If a specific ratio were to be included in the advice, this respondent felt that it should be sufficiently high and then subject to review in the light of more data.

Question 2: CESR is requested to advise the Commission on the content of the obligations to report and provide information referred to in paragraphs 1 through 5

On the issue of a standard template for reporting to competent, one respondent took the view that the specific items to be reported should not be assumed to have the same relevance for all AIFSs e.g. in their view, counterparty risk for real estate funds was generally negligible and the parties to rental agreements for the properties held in the portfolio should not be considered for the purposes of the counterparty risk calculation.

One contributor saw merit in the development of a template to foster a standardised approach, while noting that the IOSCO document related to hedge funds only and therefore may not be appropriate to private equity or real estate. The same respondent also felt that ESMA should develop a harmonised definition of the main categories of asset and was of the view that the bullet points included in the mandate went beyond the power conferred by Art. 24(6).

Finally, one respondent favoured use of a regulation for the implementing measures in this area.

Question 3:

Two respondents felt that annual reporting would be sufficient. One of them saw merit in allowing the possibility for ad hoc requests for further information, while the other one felt additional reporting should be limited to changes to the status of the information provided (e.g. a change in the liquidity management of the AIFs).

One contributor favoured aligning the reporting period to the financial year of the AIF in order to avoid competent authorities being swamped with information at a particular time.

Regarding the development of a template, one stakeholder called for ESMA to take into account the need to minimise the administrative burden and to recognise that the specific items for reporting should not be assumed to have the same relevance for all types of AIF (e.g. for real estate funds counterparty risk is mostly negligible).

Question 4: In its advice, CESR should consider developing a comprehensive template to be used by AIFM for reporting to competent authorities the information required under Article 24. In developing such a template, CESR should take into account the reporting template issued by IOSCO on 25 February 2010 for reporting from hedge funds and templates used by national competent authorities. CESR should address inter alia the following elements:

- **Assets under management;**

- **Performance and investor information;**

- **Market and product exposure (long and short positions);**
- **Regional focus;**
- **Turnover and number of transactions, indication of markets in which trading canrepresent a significant proportion of overall volume, trading and clearing mechanisms;**
- **Leverage and risk;**
- **Asset and liability information; and**
- **Counterparty risk**

The template should be sufficiently flexible to accommodate the different types, sizes and investment strategies of AIFM, without compromising the objective of effective supervision.

Two respondents were of the view that annual reports to competent authorities should suffice for many AIFs and that it would be better to wait to have experience of the functioning of the Directive before reviewing the requirements. The same respondents called for the advice to take into account current practices with regard to reporting to competent authorities (e.g. reporting formats).

Issue 23 – Article 25, Use of information by competent authorities, supervisory co-operation and limits to leverage

Question 1: CESR is requested to advise the Commission on the principles specifying the circumstances in which competent authorities shall exercise the powers granted pursuant to Article 25(3), taking into account different strategies of AIF, different market conditions in which AIF operate and possible pro-cyclical effects following from exercising the provisions. Such principles should guide competent authorities in identifying situations and circumstances in which competent authorities shall exercise the powers referred to in paragraph 3.

In the view of several respondents the intervention powers foreseen in Art. 25(3) should be limited to exceptional circumstances. These respondents called on ESMA to develop clear criteria for the exercise of these powers and to engage in a continuous exchange of views in order to fulfil the co-ordination and facilitation role envisaged under Art. 25(5).

One respondent set out a number of arguments explaining that AIF generally do not pose systemic risk and that efforts to mitigate risks arising from leverage would be more appropriately directed towards leverage providers/lenders.

ESMA was requested to take into account IOSCO's principles for hedge funds and recognise that investors' interests could be harmed by any decision to require an AIF to deleverage within a short period of time; in their view, better disclosure and appropriate internal controls (including of conflicts of interest) were the solution. Another respondent agreed with this point, stating that the AIFM should be allowed to reduce positions within a reasonable period of time and in way that is consistent with the investors' best interests.

One contributor noted that some counterparties already centralised some information on leverage of which competent authorities could make use when collecting and consolidating such data.

Finally, one stakeholder stressed that private equity and venture capital funds did not create systemic risk and, as such, the requirements in Art. 25 were not relevant.

Question 2: In its advice, CESR should consider inter alia to what extent the following aspects might endanger the stability and integrity of the financial system:

- **leverage used in different strategies and the size of an AIF's 'footprints';**

- **the concentration of risks in particular markets and risks of spill-over effects; liquidity issues in particular markets; counterparty risks to credit institutions or other systemically relevant institutions; the scale of any asset/liability mismatch; and**

- **the evolution of prices of assets with respect to their fundamentals.**

One respondent called on ESMA to adopt the same approach as set out by the FSA in its February 2010 report: http://www.fsa.gov.uk/pubs/other/hedge_funds.pdf

Question 3: CESR is also requested to advise on the appropriate timing of potential measures referred to in Article 25(3).

One respondent saw merit in establishing a transparent procedure in the context of leverage limits, which could consist of several stages i.e. a warning by the relevant competent authority followed by an opportunity for the AIF to explain and demonstrate its proposed approach to addressing the excessive leverage.

Annex V

Pro-forma for AIFM Reporting to Competent Authorities (Article 24)

This annex contains a pro-forma template to be used by the competent authorities in respect of the obligations in Article 24 of the AIFMD for AIFM in their Member State to regularly report/provide/make available certain information in accordance with paragraphs 1,2 and 4 of Article 24.

As well as containing the information required under Article 24, to provide competent authorities with a comprehensive set of regularly reported information on the AIFM in their Member State the pro-forma template also contains certain general information on the AIFM which would either be provided to competent authorities as part of the authorisation process or would be required as a matter of general reporting.

The European Commission is required to adopt a delegated act specifying the obligations to report and provide the information specified under Article 24 of the AIFMD. In order to ensure a harmonised framework for the reporting/collection of this information it is necessary to ensure a high level of precision in the specification of the format and content of this data. However, to reflect the dynamic nature of the activities of AIFM and the environment in which they operate, it is appropriate to ensure that the individual items and elements of data that comprise this framework to enable competent authorities to undertake a comprehensive assessment of the regulatory risks arising from these activities. As such, for those elements and items of data which are provided in a 'discrete' form (e.g. a list from which a selection is made), whilst it is appropriate to clearly specify the format and content of the data item or element it would appear appropriate for ESMA to consider the provision of guidelines to specify the set of discrete items from which the reported data is selected. In the case of the investment strategies adopted by AIFM, such an approach would enable new strategies which emerge over time to be included within the overall reporting framework. We have attempted where possible to make the format and questions consistent with other international surveys (such as by IOSCO and the proposals under the US Dodd-Frank) to aid in the international comparison of data. It is envisaged there will be guidance and definitions to help completion of the survey questions.

Article 24 contains three distinct obligations on AIFM to 'report', 'provide' or 'make available' information to the competent authorities of their home Member State. The relevant references to the obligations in Article 24 and in the Box 109 of the consultation paper are contained in the 'AIFMD ref' column of the pro-forma. The following key is used to indicate the elements of the pro-forma that relate to the obligations under Article 24 (and the corresponding requirements in the Box 109 of the consultation paper.

Provisions in Article 3(3)(d) and Article 24(1) to 'provide regularly' /'regularly report' to the competent authorities.

Provisions in Article 24(2) to 'provide' to competent authorities
Provisions in Article 24(4) to 'make available' information to the competent authorities.
Additional general information to be collected by competent authorities.

AIFMs must complete this pro-forma for all AIFs that were in existence at any time during the reporting period regardless of whether they are open or closed to new investments, in 'run off' or not in existence at the end of the reporting period. The reporting period in this regard refers to the time between the reporting date and the previous reporting date in accordance with Box 109 (Format and Content of reporting to Competent Authorities).

The reporting pro-forma contains the following overarching structure:

Section 1 – Main Instruments Traded and Individual Exposures comprising data on investment strategy, geographical focus, individual exposures and portfolio turnover.

Section 2 – Most Important Concentrations comprising data on principal markets in which AIFM trading represents a significant proportion of overall daily market volume, investor concentration, portfolio concentration and controlling influence exercised by AIF

Section 3 – Risk Profile of the AIF comprising data on market risk, counterparty risk, liquidity risk, borrowing risk, exposure risk, operational risk and other risks

As Section 1 of the document comprises data of a more generic nature, this information will be reported on an AIFM basis. The data comprising sections 2, 3 and 4 of the pro-forma relates to AIF-specific information and this will be reported on an AIF basis. As such, AIFM managing more than one AIF will be required to submit information for each AIF [which is of a material size].

AIFMD Ref Lvl 1	AIFMD Ref Lvl 2	Q	Data Type	Reported Data
Section 1 – Main Instruments Traded and Individual Exposures				
1	1 a)	**1**	**Predominant Investment Strategy (select one)** **a) Hedge Fund Strategies** **b) Real Estate Fund** **c) Private Equity Fund** **d) Fund of Funds** **e) Other**	
1	1 a)	**2**	**Predominant geographical focus**	

AIFMD Ref Lvl 1	AIFMD Ref Lvl 2	Q	Data Type		Reported Data		
			a) Developed Markets				
			b) Multiple Emerging Market(s)				
			c) Global Markets (Developed & Emerging)				
1 & 2d)		**3**	**Individual Exposures (in € '1000s) representing the main instruments in which it is trading and the main categories of assets in which the AIF invested as at the reporting date:**				
			a) Securities (market values)		*Long Value*	*Short Value*	*Gross Value*
1	1 a)		Listed equities				
2 d)	2 d)		Of which are:	Issued by financial institutions			
				Other listed equity			
1	1 a)		Unlisted equities				
			Money market Instruments				
			Corporate bonds				
2 d)	2 d)		Of which are:	Investment grade			
				Non-investment grade			
1	1 a)		Sovereign bonds				
2 d)	2 d)		Of which are:	G10 bonds with a 0-1yr term to maturity			
				G10 bonds with a 1+yr term to maturity			
				Non-G10 bonds			
1	1 a)		Financial institution bonds				
			Convertible bonds				
			Loans				
2 d)	2 d)		Of which are:	Leveraged loans			
				Other loans			
1	1a)		Structured/securitised products				
2 d)	2 d)		Of which are:	ABS/CDO/ WBS			
				RMBS			
				CMBS			
				Agency MBS			
				ABCP			

AIFMD Ref Lvl 1	AIFMD Ref Lvl 2	Q	Data Type		Reported Data		
				CLO			
				Other			
1 & 2d)			**b) Derivatives (notional values, delta adjusted notional for options)**		*Long Value*	*Short Value*	*Gross Value*
1	1 a)		Equity derivatives				
2 d)	2 d)		Of which are:	Issued by financial institutions			
				Other equity derivatives			
1	1 a)		Fixed Income derivatives				
			CDS				
2 d)	2 d)		Of which are:	Single name financial CDS			
				Single name sovereign CDS			
				Single name other CDS			
				Index CDS			
				Exotic (incl. credit default tranche)			
					Gross Value		
1	1 a)		Foreign exchange (for investment purposes)				
			Interest rate derivatives				
					Long Value	*Short Value*	*Gross Value*
			Commodity derivatives				
2 d)	2 d)		Of which are:	Crude oil			
				Natural gas			
				Gold			
				Power			
				Other commodities			
					Long Value	*Short Value*	*Gross Value*
1	1 a)		Other derivatives				
1 & 2d)			**c) Real Assets**		*Long Value*		
1	1 a)		Physical Commodities				
1	1 a)		Physical Real Estate				

AIFMD Ref Lvl 1	AIFMD Ref Lvl 2	Q	Data Type	Reported Data
1 & 2d)			**d) Collective Investment Undertakings**	*Long Value*
1	1 a)		Investments in CIU operated/managed by the AIFM	
			Of which are: Cash management CIU	
			Other CIU	
1	1 a)		Investments in CIU not operated/managed by the AIFM	
			Of which are: Cash management CIU	
			Other CIU	
				Long Value / *Short Value* / *Gross Value*
1 & 2d)			**e) Investments in other asset classes (market values)**	
1	1 a)		Total Other	
			f) Typical deal/position size	
1 & 2d)			Very small (<€5m) / Small (€5m to €25m) / Lower Mid Market (€25m to €150m) / Upper Mid Market (€150m to €500m) / Large Cap (€500m to €1bn) / Mega Cap (>€1bn)	
2 d)	2 d)	**4**	**Value of turnover in each asset class over the reporting months (in € '1000s)**	
			a) Securities	*Market Value*
			Of which are: Listed equities	
			Unlisted equities	
			Money market Instruments	
			Investment grade corporate bonds	
			Non-investment grade corporate bonds	
			Sovereign bonds - G10	
			Sovereign bonds - Non G10	
			Financial institution bonds	
			Convertible bonds	
			Loans	
			Structured/securitised products	
			b) Derivatives	*Notional Value* / *No of Contracts*
			Of which are: Equity derivatives	
			Fixed Income derivatives	
			CDS	

AIFMD Ref Lvl 1	AIFMD Ref Lvl 2	Q	Data Type		Reported Data	
				Foreign exchange (for investment purposes)		
				Interest rate derivatives		
				Commodity derivatives		
				Other derivatives		
			c) Real Assets (market value)		*Market Value*	
			Of which are:	Physical Commodities		
				Physical Real Estate		
				Other Funds		
			d) Other asset classes (market value)			

Section 2 – Most Important Concentrations

Most Important Concentrations

1	1 c)	**5**	**Principal markets in which your trading can represent a significant proportion of overall daily market volume**		
			Please enter name of market (leave blank if none or not applicable)		
			Please enter name of market (leave blank if none or not applicable)		
			Please enter name of market (leave blank if none or not applicable)		
1	1 c)	**6**	**Investor Concentration**		
			Percent of NAV that is owned by the largest investor in the AIF (as a % of outstanding units/ shares of the AIF)		
			Number of investors owning 5% or more of the outstanding units/ shares of the AIF		
1	1 c)	**7**	**Portfolio Concentration**		
			Top ten positions as a % of gross market value (GMV):		
		8	**Controlling Influence**	*Name*	*% Voting Rights*	*Transaction Type*
			Please enter name of each company over which the AIF has a controlling influence (leave blank if none) as defined in Article 1 of Directive 83/349/EEC			

AIFMD Ref Lvl 1	AIFMD Ref Lvl 2	Q	Data Type	Reported Data		

Section 3 – Risk Profile of the AIF

a) Market Risk Profile

2(c)	2 (c)(ii)	**9**	**Expected return and risk profile of the investment strategy during normal market conditions**	
			a) Expected annual investment return/IRR in normal market conditions (in %)	
			(please skip the remainder of this question and go to question 14 if you selected as your predominate investment strategy 'real estate fund ', 'private equity fund', or infrastructure fund in question 1)	
			b) Expected annualised volatility in normal market conditions (in %)	
			c) Expected worse quarterly loss in normal market conditions (in %)	
2(c)	2 (c)(ii)	**10**	**Value at Risk of AIF**	
			a) During the reporting period, did you regularly calculate the VaR of the AIF?	Yes No (if no, skip remainder of the question and go to question 11)
			b) Confidence Interval used (e.g. 1-alpha)	
			c) Time horizon used (in days)	
			d) Weighting method used	[Select one] None Equal Geometric Other
			e) If geometric weighting is used, provide the weighting factor	
			f) Methodology used to calculate the VAR:	[Select one] Monte Carlo simulation Historical simulation Parametric Other
			g) Historical lookback period used (in number of years)	
			h) Value at risk as at the reporting date (as % of NAV of AIF assets)	

AIFMD Ref Lvl 1	AIFMD Ref Lvl 2	Q	Data Type	Reported Data
2c)	2 (c)(ii)	11	**Net Equity Delta if applicable (in € '1000s)**	
2c)	2 (c)(ii)	12	**Net DV01 if applicable (in € '1000s):**	
2c)	2 (c)(ii)	13	**Net CS01 if applicable (in € '1000s):**	
			b) Counterparty Risk Profile	
2c)	2 (c)(i)	14	**Trading and clearing mechanisms**	
			a) Estimated % (in terms of market value) of securities traded: (leave blank if no securities traded)	*%*
			On a regulated exchange	
			OTC	
2c)	2 (c)(i)		**b) Estimated % (in terms of trade volumes) of derivatives that are traded:** (leave blank if no derivatives traded)	*%*
			On a regulated exchange	
			OTC	
2c)	2 (c)(i)		**c) Estimated % (in terms of trade volumes) of derivatives transactions cleared:** (leave blank if no derivatives traded)	*%*
			By a CCP	
			Bilaterally	
2c)	2 (c)(i)		**d) Estimated % (in terms of market value) of repo trades cleared:** (leave blank if no repos traded)	*%*
			By a CCP	

AIFMD Ref Lvl 1	AIFMD Ref Lvl 2	Q	Data Type	Reported Data	
			Bilaterally		
			Tri-party		
2c)	2 (c)(i)	**15**	**Trading counterparties (excluding CCPs)**		
			a) Please list your top five trading counterparties that have the greatest net counterparty credit exposure to the AIF ***See Table Page 435**	*Name*	*Total Exposure (in € '1000s)*
			Counterparty 1		
			Counterparty 2		
			Counterparty 3		
			Counterparty 4		
			Counterparty 5		
2c)	2 (c)(i)		**b) Total value of collateral posted to net credit counterparties in a) (report in € '1000s)**		
2 c) & 4	2 (c)(i) &		**c) Percentage of collateral in (b) that may be rehypothecated**		
2c)	2 (c)(i)		**d) Percentage (if any) of your total net credit counterparty exposure with unregulated entities?**		
2c)	2 (c)(i)	**16**	**Top three central clearing counterparties (CCPs) in terms of net credit exposure?**	*Name*	*Value held (in € '1000s)*
			CCP 1 *(leave blank if not applicable)*		
			CCP 2 *(leave blank if not applicable)*		
			CCP 3 *(leave blank if not applicable)*		
			c) Liquidity Risk Profile		
2c)	2 (c) (i) & (iii)	**17**	**Portfolio liquidity**		
			a) Percentage of portfolio capable of being liquidated ***See Table Page 435**		
			<1 day ☐ 2 - 7days ☐ 8 - 30 days ☐ 31 - 90 days ☐ 91 - 180 days ☐ 181 – 365 days ☐ 366 days + ☐		
			b) Value of 'tier/level 3' net assets (valuation based on unobservable inputs) (% of		

AIFMD Ref Lvl 1	AIFMD Ref Lvl 2	Q	Data Type	Reported Data
			NAV)	
			c) Unencumbered cash (in € '1000s)	
		18	**Investor liquidity**	
			a) Current Investor Liquidity Profile (as % of AIF's NAV)	
			<1 day ☐ 2 - 7days ☐ 8 - 30 days ☐ 31 - 90 days ☐ 91 - 180 days ☐ 181 – 365 days ☐ 366 days + ☐	
2c)	2 b)		**b) Does the fund have the ability to suspend investor redemptions and/or create side pockets?**	(Yes or No)
2a) & 2c)	2 a)		**c) Please specify any arrangements for managing the liquidity of the AIF currently in operation**	
			Side pocket created and still in existence	
			Gate imposed	
			Suspension of dealing in place	
			Other (please specify)	
2a) & 2c)	2 a)		**d) Indicate the percentage of net asset value of AIF's assets that are currently subject to the special arrangements arising from their illiquid nature under Article 23 (4) (a) of the AIFMD?**	
			Special arrangements as a % of NAV	
			e) Are there any investors who obtain preferential treatment or the right to preferential treatment (e.g. through a side letter) and therefore are subject to disclosure to the investors of the AIF in accordance with Article 23(1)(j) of the AIFMD?	
2c)	2 a)		If 'yes' to q 18(e) then please indicate all relevant preferential treatment:	(Yes or No)
			Concerning different disclosure/reporting to investors	
			Concerning different investor liquidity terms	
			Concerning different fee terms for investors	
			Preferential Treatment other than that specified above	
			f) Frequency of investor redemptions (if multiple classes of shares or units, report for the largest share class by NAV)	

AIFMD Ref Lvl 1	AIFMD Ref Lvl 2	Q	Data Type	Reported Data
			g) Notice period required by investors for redemptions in days (report asset weighted notice period if multiple classes or shares or units)	
			h) Investor 'lock-up' period in days (report asset weighted notice period if multiple classes or shares or units)	
			i) Ownership by investor group (% of NAV of AIF assets)	%
2c)	2 c) (i)		Employees and staff of the AIFM	
			High net worth individuals and family offices	
			Banks, insurance companies and other financial institutions	
			Pension plans/funds	
			Endowments/foundations and charitable organisations	
			State, municipal and other government entities, and sovereign wealth funds	
			Other collective investment undertakings (e.g. fund of funds)	
			Other types of investors	
2c)	2 (c) (iii)	**19**	**Financing liquidity**	
			a) Aggregate amount of borrowing by and cash financing available to the AIF	
			b) Gross exposure of financial and/or legal structures controlled by the AIF as defined in Recital 78 of the AIFMD	
			Financial and/or legal structure	
			Financial and/or legal structure	
			Financial and/or legal structure	
			…..	
			c) Financing term (% locked for): *See Table Page 435	

AIFMD Ref Lvl 1	AIFMD Ref Lvl 2	Q	Data Type	Reported Data
			<1 day ☐ 2 - 7days ☐ 8 - 30 days ☐ 31 - 90 days ☐ 91 - 180 days ☐ 181 – 365 days ☐ 366 days + ☐	
			d) Borrowing and Exposure Risk	
4 & 2 c)	4 & 2 (c) (i)	**20**	**Current value of borrowings (in € '1000s) of cash or securities represented by:**	
			a) Unsecured cash borrowing:	
			Collateralised/secured cash borrowing – Via Prime Broker:	
			Collateralised/secured cash borrowing – Via repo:	
			Collateralised/secured cash borrowing – Via Other:	
			Security borrowings for short positions:	
		21	**Borrowing embedded in financial instruments (in € '1000s)**	
			Exchange-traded Derivatives: Gross Exposure less margin posted	
			OTC Derivatives: Gross Exposure less margin posted	
		22	**Exposure of the AIF**	
			a) Gross Method	
			b) Commitment Method	
			c) Advanced Method (where calculated)	
			e) Operational and Other Risk Aspects	
2c)	2 (c) (i)	**23**	**a) total number of open positions**	
		24	**Historical risk profile**	
			a) Gross Investment returns or IRR of the AIF over the reporting period (in %, gross of management and performance fees)	
			1st Month of Reporting Period	
			2nd Month of Reporting Period	
			.	

AIFMD Ref Lvl 1	AIFMD Ref Lvl 2	Q	Data Type	Reported Data
			.	
			.	
			Last Month of Reporting Period	
			b) Net Investment returns or IRR of the AIF over the reporting period (in %, net of management and performance fees)	
			1st Month of Reporting Period	
			2nd Month of Reporting Period	
			.	
			.	
			.	
			Last Month of Reporting Period	
			c) Change in Net Asset Value of the AIF over the reporting period (in %, including the impact of subscriptions and redemptions)	
			1st Month of Reporting Period	
			2nd Month of Reporting Period	
			.	
			.	
			.	
			Last Month of Reporting Period	
			c)Subscriptions over the reporting period	
			1st Month of Reporting Period	
			2nd Month of Reporting Period	
			.	
			.	
			.	
			Last Month of Reporting Period	
			d) Redemptions over the reported period	

AIFMD Ref Lvl 1	AIFMD Ref Lvl 2	Q	Data Type	Reported Data
			1st Month of Reporting Period	
			2nd Month of Reporting Period	
			.	
			.	
			.	
			Last Month of Reporting Period	

It is envisaged that a common framework for the inclusion of data of a numerical or currency type is adopted. ESMA proposals that such data is reported under a common specification (e.g. in € 1000's) and any conversion of exchange rates to Euros is at a consistent exchange rate (e.g. the spot exchange rate at the last fixing time on the previous business day before the reported date of the data.

Sample Guidance for AIFMs when completing pro-forma

Q1 **Predominant Investment Strategy**

Select the most appropriate investment strategy depending on AIF type.

Hedge Fund	Private Equity Fund	Fund of Funds	Other Fund
Equity Long / Short	Venture Capital	Fund of Hedge Funds	Commodity Fund
Equity Market Neutral	Growth Capital	Fund of Private Equity Funds	Long only Equity Fund
Equity Short Bias	Mezzanine Capital	Other Fund of Funds	Long only Fixed Income Fund
Relative Value: Convertible Bond Arbitrage	Multi-Strategy Private Equity Fund		Infrastructure Fund
Relative Value: Fixed Income Arbitrage	Other private equity fund strategy		Other Fund (Please specify)
Relative Value: Volatility Arbitrage			
Event Driven: Credit Distressed			
Event Driven: Risk Arbitrage / Merger Arbitrage			
Event Driven: Equity Special Situations			
Event Driven: Multiple Event Driven			

Credit Long / Short
Credit Long Biased / Asset Based
Lending
Global Macro
Managed Futures / CTA
Multi-Strategy Hedge Fund
Other hedge fund strategy

Q2 **Predominant Geographical Focus**

Select the main geographical focus on the AIF. For developed markets, specify either 'North America, Europe, Asia/Pacific, or Multiple Developed Markets'

Q16 **Trading counterparties (excluding CCPs)**

a) Please list your top five trading counterparties that have the greatest net counterparty credit exposure to the AIF

Treat affiliated entities as single groups. CCPs should not be regarded as trading counterparties. Take into consideration (i) mark to market gains and loses on derivatives; (ii) margin posted to the counterparty; and (iii) any loans or loan commitments. Do not take into consideration (i) assets that the counterparty is holding in custody on the AIFs behalf; (ii) securities transactions that have been executed but not yet settled; (iii) margin held in a customer omnibus account at a CCP (which should be consider an exposure to a CCP); or (iv) debt or equity securities issued by the counterparty.

Q17 **Portfolio liquidity**

a) Percentage of portfolio capable of being liquidated:

Specify the percentage of the reporting fund's positions that may be liquidated within each of the periods specified below. Each investment should be assigned to only one period and such assignment should be based on the shortest period during which such position could reasonably be liquidated at or near its carrying value. Use good faith estimates for liquidity based on market conditions over the reporting period and assuming no fire-sale discounting (e.g., for listed equities, assume that you will not trade more than 20% of the 90 day average daily trading volume in a single day). In the event that individual positions are important contingent parts of the same trade, group all those positions under the liquidity period of the least liquid part (so, for example, in a convertible bond arbitrage trade, the liquidity of the short should be the same as the convertible bond). Exclude cash and cash equivalents. The total should add up to 100%

Q18 **Investor liquidity**

a) Investor Liquidity (as % of AIF's NAV)

Divide the AIF's NAV among the periods indicated depending on the shortest period within which invested funds could be withdrawn or investors

could receive redemption payments, as applicable. Assume that you would impose gates where applicable but that you would not suspend withdrawals / redemptions and that there are no redemption fees. Please base on the valuation date rather than the date paid to investor, the total should add up to 100%

f) Frequency of Investor Redemptions

Select the frequency of investor redemptions as appropriate as 'daily, weekly, fortnightly, monthly, quarterly, biannually, annually, other (please specify).

Q19 **Financing liquidity**

a) Aggregate Borrowing and Cash Financing

Include all drawn and undrawn, committed and uncommitted lines of credit as well as any term financing

e) Financing term (% locked for):

Divide the amount reported in response to Question 23 a) among the periods indicated depending on the longest period for which the creditor is contractually committed to provide such financing: If a creditor (or syndicate or administrative/collateral agent) is permitted to vary unilaterally the economic terms of the financing or to revalue posted collateral in its own discretion and demand additional collateral, then the financing should be deemed uncommitted for purposes of this question. Uncommitted financing should be included under '1 day or less.'). The total should add up to 100%.

Q24 (a) **Historical risk profile**

a) Investment returns of the AIF over the reporting period (in %)

Please indicate the monthly performance of net asset value of AIF's assets (% increase/ decrease) net of fees and excluding the impact of subscriptions and redemptions, unless the AIF does not calculate its NAV on a monthly basis in which case the AIF's performance shall be reported for the survey period in full (fill in 'last month' cell).

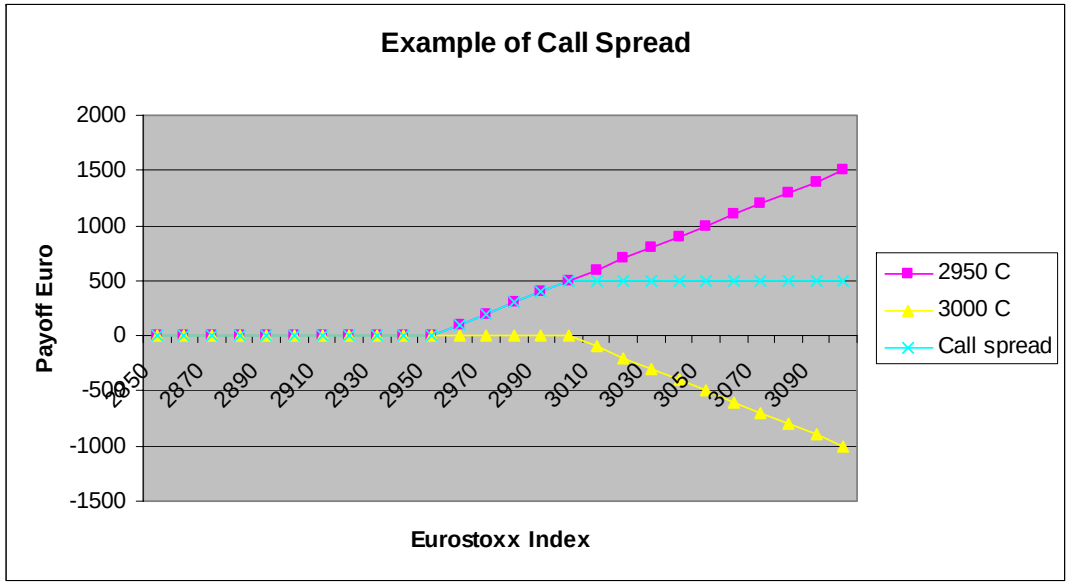
Q24(b) **b) Change in total NAV of the AIF over the reporting period (in %)**

Please indicate the monthly changing of net asset value of AIF's assets (% increase/ decrease), net of fees and including the impact of subscriptions and redemptions, unless the AIF does not calculate its NAV on a monthly basis in which case the AIF's performance shall be reported for the survey period in full (fill in 'last month' cell).

Annex VI

Example application of the Commitment Method of Calculating the Exposure of an AIF to 'option strategies'

This graph shows the payoff profile for two options ('2950 C' and '3000 C') for June 2011 calls on Eurostoxx (VGM1 code in Bloomberg) and the combined payoff profile ('Call Spread'). It can be seen from the Call Spread that there are boundaries to the losses that can be suffered by an AIF undertaking this strategy.



Numerical Explanation

The current June 2011 futures price (VGM1 code in Bloomberg) is 2893

2950 C - The 2950 calls are worth 47 index points. With the unit size of €10 per index point, they cost **€470**.Their delta is currently 37%, so that the delta adjusted equivalent of the underlying position is 2950* 37% * €10 = **€10,915.** You can see that to get this payoff for this option the index would have to move significantly i.e. it would go off the graph.

But the max loss is only the premium paid of €470 which is far less than the delta equivalent of the underlying position.

3000 C - We can extend this to a call spread by adding a short position in 3000 calls. They have a current price of 30 index points and with a unit size of €10 per index point the premium equals **€300**. Their delta is currently 27%, so the delta adjusted equivalent of the underlying position is 3000 * 27% * €10 = (**€8,100)**

Conclusion:
Net premium paid (**€170)** = (€470) + €300.
Net Exposure under the commitment approach **€2,850** = €10,915 + (€8,100)
Difference between the two figures = 1702%