CD/SJ – 09.01.2012

ESMA final advice to the Commission
AFG Comments

The final advice sent by ESMA to the Commission on 16th November 2011 is globally unchanged compared to the proposals it submitted to public consultation.

However, some of the changes ESMA proposes in its final advice are significant to AFG Members. You will find AFG's position on ESMA's new proposals hereafter (please see text highlighted in pink).

In addition, AFG proposes complementary improvements (please see rest of the text).

General comments

AFG appreciates the approach followed by ESMA to ensure that the implementing measures of the AIFMD are **as far as possible in line with existing regulations** such as the UCITS Directive or the MiFID. Indeed, many AIFMs also manage UCITS funds or provide MiFID services and it would be very difficult for them to comply with inconsistent sets of rules. However, this should of course not prevent, where appropriate, any differentiation between UCITS and AIFs due to the different nature of these two types of funds.

AFG generally supports the implementation of the principle of **proportionality** throughout all level 2 measures, in particular with regards to risk and liquidity management. Indeed, we should bear in mind that **the large majority of AIFs throughout Europe are "UCITS like" funds** that would be subject to too burdensome and costly requirements if the rules were applied in an indiscriminate manner to all AIFs whatever their type or size. For instance in France, nationally regulated "general purpose" funds, which are non UCITS and therefore considered now as AIFs, represent an AUM of EUR 560 Billion (bearing in mind that French investment funds in the scope of the AIFMD total AUM is EUR 712 billion). The same proportion is true throughout Europe. It should in particular be ensured that such principle of proportionality is applied regarding the general operating conditions (risk management) and transparency.

We find the information provided in the **explanatory text** throughout the paper detailed and very helpful. On the other hand, the text proposed in the boxes might lack clarity in some instances. It would therefore be useful to include some of the explanations or definitions contained in the explanatory text in the Articles of the L2 texts themselves. This is for example the case for provisions which should be applicable to specific funds only.

It has been announced that the Commission would not organise any public consultation on the level 2 measures it is to develop. AFG Members believe that **this approach is unsatisfactory as the task of transposing technical wording into legal texts is not simple and inevitably requires drafting adaptations which may have a significant impact on market participants.**

In addition, not having language versions of the draft texts submitted to consultation will lead to national inconsistencies implementations afterwards - contradicting the European Commission's general aim of harmonisation. At least a consultation in the three working languages of the Commission should be carried out.

We would like to reassert to the Commission that we are in favour of a harmonised implementation of the Directive at EU level and would generally support a more active role for ESMA.

A clarification of the scope of the Directive would be very useful regarding dedicated funds and funds with a sole investor. AFG would indeed like to request a general clarification: are **AIFs with only one investor** caught by the directive or not? There is a risk of regulatory dumping if this is not applied in the same way throughout the EU: for example, to our knowledge, Luxembourg intends to put them out of the scope of the directive, while Germany and France will put them in, based on different interpretations of the Directive. **Clarification on this point of interpretation must be urgently done at EU level.**

Detailed comments

Box 1 - Methodology for calculating of the total value of assets under management

"For the purpose of calculating the value of assets under management, each financial derivative instrument position, including derivatives embedded in transferable securities, should be converted into its equivalent position in the underlying assets of that derivative using the conversion methodologies set out in Box 99. The absolute value of this equivalent position should then be used for the calculation of the total assets under management. However, foreign exchange and interest rate hedging positions that according to the investment strategy of the AIF are not used to generate a return should not be taken into account for the calculation of the total value of assets under management"

AFG would like to underline the need for consistency in the methodology for calculating the total value of assets under management in order to allow for comparability.

Box 1 - We support the exclusion of cross-holdings in the calculation of the value of total assets under management (AUM) as this will avoid double-counting the same assets.

5 – "AIFMs should implement and apply procedures to monitor the value of total assets under management"

We feel that there might be some inconsistency between the requirement to calculate the total value of AUM and the obligation to monitor it. It would be useful to specify that such monitoring does not involve a "full and proper" valuation of the assets but an estimate.

In particular, where the value of the assets is not calculated on a frequent basis, AIFMs should be allowed to use estimations of the value of the assets in the portfolio. Indeed, it would be too burdensome and costly to require them to produce "full and proper" calculations (involving for example the obligation to resort to external valuers for real estate funds) on a more frequent basis.

We would therefore suggest re-wording paragraph 1 of the box as follows:

"Calculate **at an appropriate frequency** the value of the assets under management".

6.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."

We think that the requirement "without delay", which means immediately, is not realistic in practice. We would therefore suggest re-wording as follows:

"the AIFM should notify the competent authority without <u>undue</u> delay"

In addition, we believe that the delay granted to notify the competent authority should be of one month where the net asset values (NAVs) of all the AIFs considered are calculated on a monthly basis and longer if the NAVs of the AIFs considered are calculated on a less frequent basis: as far as possible, we must consider the AUMs calculated for NAV purposes, and not a *permanent* calculation of the AUMs. It would be a practical case of proportionality to be applied for this Directive.

6.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."

We believe that the temporary nature of the situation should be assessed over a period longer than 3 months - depending on the frequency of the NAV calculation, i.e. a period of at least 6 months as some NAVs are calculated on a monthly basis or sometimes at an even lower frequency. It would be a practical case of proportionality to be applied for this Directive.

As explained above, the Commission should make clearer in the Articles of the L2 text that "monitoring" does not imply "calculating", as some NAVs are calculated at a low frequency and not on an ongoing basis.

<u>Box 2 - Information to be provided as part of registration -</u>

2 – "(…) The description of the investment strategy should <u>at least</u> include the following information: (…)"

We think that it is key to harmonise at EU Level what can be required from national regulators, both to ensure an equal treatment of AIFMs wherever they are domiciled and also because otherwise pan-European AIFMs might face different requirements from one country to another and it would not be easy to manage. We suggest therefore the deletion of "at least":

"The description of the investment strategy should ~~at least~~ include the following information"

4 – "The updated information referred to in Article 3 should be provided on an annual basis"

We agree that the provision of updated information should be made on an annual basis.

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

As above, we are concerned that a non exhaustive list of information and the discretion allowed to competent authorities regarding the frequency of such information may lead to a lack of harmonisation among the Member States and in turn create difficulties for AIFMs belonging to pan-European groups. We believe that an exhaustive list and a frequency set at EU level would be more appropriate – or it should be decided at EU level by ESMA (in exceptional circumstances for instance).

We therefore suggest re-wording paragraph 5 as follows:

"**ESMA** may require the AIFM to provide the information set out in paragraph 1 and 2 on a more frequent basis.

Box 3 - Opt-in Procedures

AFG approves the approach proposed by ESMA regarding opt-in procedures. Indeed, we believe that there is no reason not to apply the same rules to AIFMs that choose to opt-in.

We further agree that AIFMs should only be required to submit information not previously provided for registration purposes and, in case there has been a material change to that information, to update it.

Definition of the leverage (box 94 ESMA final advice / box 2 ESMA consultation)

We would like to highlight the need for consistency between the definition of the leverage and its calculation method.

In our view, the definition of the leverage as the ratio between the exposure of an AIF and its net asset value is simple and reasonable.

AFG would like to reiterate that it strongly opposes the use of the gross method of calculating the leverage. It would be misleading if disclosed to investors as it would not allow for comparisons with UCITS - which use other calculation methods. At worst, the disclosure of the gross leverage should be limited to regulators only, in the context of monitoring systemic risk, at least in order not to mislead investors.

Box 5 – Potential risks arising from professional negligence

We welcome the removal of the reference to « relevant persons » in the definition of the potential risks to be covered and the rewording relating to the risk of fraud.

5.2.b.i – "Those risks particularly include negligent loss of documents evidencing title of assets of the AIF"

We suggest rewording as follows in order to avoid any duplication of responsibilities:

"Those risks particularly include negligent loss of documents evidencing title of assets of the AIF provided they are not supported by the depositary or any other entity, for instance a "notaire" in the case of real estate funds."

2.b – "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"

We believe that this obligation would be too costly for AIFMs and needs to be re-worded. Indeed, AIFMs cannot be held liable indefinitely. Moreover, current practice in the insurance industry is that losses resulting from mechanical failures are excluded from insurance coverage, unless the loss is a result of an intervention or manipulation of the AIFM. We are of the opinion that AIFMs should have an obligation of means rather than an obligation of result.

Box 6 – Qualitative requirements

AFG supports the choice for AIFMs between 3 options and welcomes the option of combining additional own funds and professional indemnity insurance in order to cover potential risks arising from professional negligence.

Box 7 – Quantitative requirements

AFG supports the quantitative requirement for additional own funds equal to 0.01% of the value of the portfolios of AIF managed by the AIFM.

3 – However, we believe that the competent authority of the home Member State of the AIFM should be allowed to increase the additional own funds requirements in exceptional circumstances only and provided it can justify such an increase to ESMA, so that it could approve it. In addition, we would suggest ESMA to set a maximum amount of additional own funds that national authorities may request. This would avoid any regulatory excesses.

Conversely, we believe that the possibility for the competent authority of the home Member State of the AIFM to reduce the additional own funds requirements at their own discretion is not appropriate. Indeed, **such national derogations might lead to regulatory dumping, as these reductions would only depend on the relevant AIFM and authority. We therefore think that such reductions should be allowed under the supervision of ESMA, in order to avoid any regulatory excesses and ensure a better articulation of the action of the different national authorities, therefore a better harmonisation of the implementation of European regulations.**

Box 8 – Professional indemnity insurance

Regarding the requirement for AIFMs to demonstrate that a third country insurance undertaking has sufficient financial strength with regard to the claims paying ability, AFG would find it useful if the Commission set objective criteria to be taken into account by the AIFM to assess such financial strength.

The calculation of the coverage of the insurance as proposed seems extremely complicated. Moreover, it depends on the claims received by the AIFM - for instance, it is not clear what happens if the AIFM does not receive any.

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."

In our opinion, there is no reason why AIFMs should be subject to such obligation while other market players are not. This would distort competition and prevent the establishment of a level playing field. Such market integrity topics must be tackled in horizontal market legislation (e.g. the Market Abuse Directive or the MiFID).

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

It seems difficult to assess the "undue" nature of costs. We would therefore urge the Commission to provide for a clear and precise definition of what "undue costs" are.

Box 11 - Due Diligence requirements

It would be useful to clarify in box 11 itself that the requirements set in paragraphs 4 and 5 only apply to AIF invested in specific types of assets i.e. assets which have a long duration, which are less liquid such as private equity and real estate funds (cf. Explanatory text - points 11, 12, 14 & 15 p.44).

It should be noted that most AIFMs already have due diligence in place as it is inherent to their business (due diligence is natural and necessary). Generally, they already document their investment decisions.

It should however be kept in mind that due diligence is charged to the fund; therefore additional requirements will necessarily imply additional costs for the AIF.

In addition, there is another reference to the "integrity of the market", which is new as compared to the UCITS Directive and should be repealed as this notion should be applied to all market participants through an horizontal market legislation (see our comment on Box 10 above).

4.a – the AIFM should "set out and update a business plan consistent with the duration of the AIF and market conditions"
4.b – "seek and select possible transactions consistent with the plan referred to under point (a)"

The requirement to "**update** a business plan consistent with **market conditions**" does not seem applicable to all types of funds, especially in situations where market conditions are volatile. A differentiation should be made among funds (real estate funds, private equity funds, funds of funds, nationally regulated retail funds).

As a consequence of the above, it seems difficult to implement the requirement set out in paragraph 4.b.

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

We believe that keeping such records for a set period of five years would be more appropriate and ensure a full harmonisation.

Box 14 – Execution of decisions to deal on behalf of the managed AIF

We welcome the clarification in Explanatory Text that Box 14 paragraph 1 shall apply to all AIF while paragraphs 2-5 only apply to those types of AIF which acquire or sell financial instruments or other assets for which best execution is relevant. We strongly urge the Commission to include this clarification directly into the Articles of the L2 texts to avoid diverging or contradictory future interpretations.

Box 15 – Placing orders to deal on behalf of AIFs with other entities for execution

We welcome the clarification in Explanatory Text that Box 15 paragraph 1 shall apply to all AIF while paragraphs 2-5 only apply to those types of AIF which acquire or sell financial instruments or other assets for which best execution is relevant. We strongly urge the Commission to include this clarification directly into the Articles of the L2 texts to avoid diverging or contradictory future interpretations.

Box 16 - Handling of orders – general principles

In our opinion the requirements proposed in box 16 are too prescriptive and too detailed. We welcome the clarification in Explanatory Text that Box 16 does not apply where the investment in assets is made after extensive negotiations on the terms of the agreement. Again, we strongly urge the Commission to include this clarification directly into the Articles of the L2 texts to avoid diverging or contradictory future interpretations.

Box 17 - Aggregation and allocation of trading order

3 & 4 - We believe that it is questionable whether AIFMs should be at all allowed to aggregate transactions for own account and transactions for AIFs, UCITS or clients' account. Indeed, there should be Chinese Walls in place preventing that kind of practice.

Box 18 - Inducements

First and foremost, we would like to clarify that the provisions in box 18 only apply in relation to the distribution of funds (AIFs or UCITS) it manages, and not in relation to discretionary mandates (which are covered by MIFID). Indeed, although the latter are not in the scope of the Directive, they might be part of the activities of an AIFM.

AFG understands that the proposed measures should apply to direct marketing by the AIFM only. We strongly disagree that they should also apply to "indirect marketing". Indeed, we do not believe that distribution via intermediaries constitutes part of the fund management

services as specified in Annex I to the AIFMD. External intermediaries who are not tied agents act in their own capacity and under their own responsibility. Their relationship to the AIFM is based upon distribution agreements which set out the duties and obligations of each party and ensure compliance with their respective legal requirements. Third-party distribution cannot be deemed part of the collective portfolio management activities and the term "marketing" in Para. 2 (b) of Annex I of the AIFMD[1] can only refer to direct distribution by the AIFM, by its tied agents, and possibly to marketing on behalf of the AIFM by a placing agent for a closed-end investment company IPO.

We do not see why distribution fees should generate conflicts of interest; fees and commissions received by intermediaries as remuneration for the distribution service are a necessary cost and are already regulated, subject to the conditions of Art. 26 (1) (b) of the MiFID Level 2 Directive and to disclosure to investors at the point of sale. In any case, we strongly believe that the AIF or the AIFM on behalf the AIF must be able to pay retrocessions to distributors or clients. In this respect, the KIID introduced for UCITS is in our opinion a good information tool for clients that would be useful also for AIFs' investors.

We suggest the Commission to develop rules that are in line with the UCITS directive, i.e. disclosure should be made to the AIF, not to the AIF's investors. This would ensure consistency with existing regulations and a better harmonisation.

Finally, we would welcome clarification regarding the treatment of ongoing fees which are not distribution fees. Indeed, we doubt it would be useful to inform investors on all the components of these ongoing fees, as investors are interested in the global cost of their investment. Therefore, we believe that a further split of the fees would not be relevant. In any case, the AIFMD regulates the marketing to professional investors which may ask for further information on a tailored basis. Consequently, the Directive should leave these disclosure rules to contractual provisions.

Box 19 - Fair treatment by an AIFM

AFG supports the alternative option initially proposed by ESMA in its consultation as it allows for a limited and restrictive requirement and therefore provides for more legal certainty.

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

We are indeed concerned that the option chosen by ESMA in its final advice is too flexible and will not allow harmonisation at EU level.

Box 24 – Strategies for the exercise of voting rights

In France, management companies are already required to have a voting policy in place with regards to investments in listed companies.

[1] Marketing is defined in Article 4 (1) (x) of the Level 1 text as '… *a direct or indirect offering or placement at the initiative of the AIFM or on behalf of the AIFM of units or shares of an AIF it manages to or with investors domiciled or with a registered office in the Union*'.

Regarding private equity funds, it seems natural that AIFM will exercise their voting rights relating to the companies they invest in.

Regarding real estate funds, it would not be appropriate to require AIFM to have a voting policy in place. Indeed, voting rights are only attached to a minor part of the assets in the portfolios of such funds.

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."

We think that this requirement is too broad and suggest re-wording it as follows:

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

Box 28 - Measurement and Management of Risk

We suggest further alignment with the UCITS directive and re-word as follows:

3.b - "Conduct, where appropriate, periodic back tests"
3.c - "Conduct, where appropriate, periodic stress tests and scenario analyses"

Box 29 - Risk Limits

We believe that the list of risks proposed in box 29 is not applicable to all types of funds. For example, it is not possible to integrate financial market risks in stress tests for real estate funds. Therefore, proportionality is needed depending on the type of fund or management.

We therefore suggest re-wording paragraph 2 as follows:

"The qualitative and quantitative risk limits for each AIF, shall, at least, cover the following risks, **where relevant**"

Box 31 - Liquidity Management Definitions

We would like the Commission to amend the definition of "special arrangement" so as to include for instance suspensions of an AIF, which by nature are special arrangements according to us.

Some AFG members foresee the use of gates, in the prospectus of the AIFs they manage and use them in the normal course of the liquidity management. In our members' view, these tools, provided that they are disclosed in the prospectus, should not be considered as special arrangements. For better clarity, our members would like to make a clear distinction between two types of gates: those that are disclosed in the prospectus and are part of the normal process of liquidity management and those that are implemented in exceptional situations and in this respect are seen as special arrangements.

Box 32 - Liquidity Management Policies and Procedures

e – "AIFMs shall implement appropriate policies and procedures to ensure that the redemption policies of the AIF are disclosed to investors, in sufficient detail"

We believe that such a requirement would be impossible to fulfil. The description of policies and procedures referred to can only be disclosed to investors in general terms – not in such a detailed manner.

f – We support the proposed re-wording of the below requirement as it allows for more flexibility:

"AIFMs shall identify the types of circumstances where tools and arrangements may be used in both normal and exceptional circumstances"

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"

In order to limit this requirement, we suggest re-wording it as follows:

"update these for any material changes or new arrangements."

Box 35 - Securitisation

AFG believes that AIFMs should only be required to check in the documentation of the securitisation product that the originator sponsor or original lender pledges to fulfil this retention requirement throughout the life of the product.

Box 48 - Control by senior management and supervisory function

AFG welcomes the rewording of the requirement for senior management to "oversee the approval of the investment strategies for each managed AIF".

Box 49 – Permanent compliance function

3 - We appreciate that it is not required to establish an independent compliance function if this would be disproportionate for the AIFM. This clarification is however only reflected in the Explanatory Text. We would suggest that it should be included into the Articles of the L2 texts to avoid future diverging interpretation by competent authorities.

Box 51 - Personal transactions

4. "'personal transaction' means a trade in a financial instrument or other asset effected by or on behalf of a relevant person"

We believe that it should be clarified that the assets are **those relevant to the concerned AIF**.

4.b.ii "any person with whom he has a family relationship, or with whom he has close links"

We are concerned that this requirement might prove too wide and burdensome.

Box 52 - Recording of portfolio transactions

AFG would like to make sure that the proposed requirements are suitable for real estate funds.

We welcome the split between transactions on an execution venue and those outside an execution venue.

Boxes 53 & 54 – Recording of subscription and redemption orders & Recordkeeping requirements

We understand that these requirements are based on the existing UCITS framework. However, it should be clarified that they are only applicable to the direct distribution of the AIF (i.e. to direct orders) and that different solutions regarding the recording of orders must be permitted in case of indirect distribution.

Box 56 - Models used to value assets

We agree that senior management should be able to understand and validate the valuation model and methodology. This is fundamental and consistent with the general principle that the responsibility of the valuation belongs to the AIFM (principle set at Level 1).

Box 57 – Consistent application of the valuation methodologies

AFG welcomes the removal of the requirement to apply the same policies and procedures 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.

Indeed, it would not make sense to apply the exact same policies, procedures and valuation methodologies to all AIFs having the same AIFM. They have to be tailored to the type of AIF (e.g. real estate fund, private equity fund…) and to the type of asset in the portfolio of the AIF (e.g. geographical zone).

Box 59 - Review of individual values

This requirement may prove burdensome, especially for small-sized AIFMs. We believe that these rules should be proportionate to the size of the AIFM.

Box 63 – Delegation

We welcome the proposals by ESMA in Box 63. The Explanatory Text is considered very important for the understanding of the proposals in Box 63, in particular the term of "critical and important functions". We therefore urge the Commission to include the clarifications of Explanatory Text directly into the Articles of the L2 text.

Box 66 – Sufficient resources and experience and sufficiently good repute of the delegate

We feel that these proposed requirements are too detailed and burdensome, and go far beyond what is required under the UCITS directive. We therefore ask for a closer alignment between the approach taken under the AIFMD and the one followed for the UCITS framework.

Box 67 – Types of institution that should be considered to be authorised or registered for asset management and subject to supervision

Delegations of portfolio management should only be allowed to entities authorised for collective portfolio management, as otherwise it would offer an easy way to circumvent the requirements of the Directive.

Box 68 – Delegation of portfolio management or risk management conferred on a third country undertaking

AFG welcomes the removal of the requirement for local criteria which are *equivalent* to those established under EU legislation.

4.e - However, it must be complemented by the new requirement introduced by ESMA in its final advice that the arrangements [between the competent authorities of the home Member State of the AIFM or ESMA and the supervisory authorities of the undertaking to which delegation is conferred should allow the EU competent authorities to perform sufficiently dissuasive enforcement actions in cases of breach of the requirements of the AIFMD and its implementing measures] should be complemented by the obligation for ESMA to coordinate such enforcement actions, for example by setting standards at level 3, or to implement such actions itself – in place of the Member States. This additional requirement would allow for more harmonisation at EU level and a more consistent implementation of the Directive.

Box 68.1 - In our opinion, the IOSCO multilateral memorandum of understanding of May 2002 is a good basis for the cooperation arrangements to be signed at EU level. However, it is not sufficient and would need to be complemented in order to suit better the specificities of these arrangements: in other words, *an ESMA template to be used at pan-European level is necessary.*

Box 68.3 - We believe that any sub-delegation should only be allowed provided the initial AIFM approves it.

Box 68.5 - We believe that *the notion of 'asset management' is too wide*: *it should be restricted to the notion of 'collective portfolio management'*, in order to avoid any circumvention of AIFMD through a delegation to an entity which does not provide collective portfolio management.

In order to avoid any misinterpretation, we believe that *all the relevant undertakings should be authorised and not merely registered*. A mere registration is not enough: non-authorised entities can be simply registered without being regulated and therefore do not provide enough guarantees.

Furthermore, the explanatory text defining the notion of independence of a third country authority should be included in the Articles of the L2 text in order to make it binding (box 68.5).

Box 74 - Letter-box entity

AFG deems that an AIFM is not a letter-box entity as long as it can control the delegations and that it performs at least one of the investment management functions listed in Annex I of the Directive.

2. "key areas"

We believe that the relevant areas should be defined as the functions described in Annex I of the level 1 directive (i.e. portfolio management and risk management).

Box 75 – Written agreement evidencing the appointment of a single depositary

AFG welcomes the fact that ESMA does not establish a model agreement.

Indeed, AFG members believe that drafting a model agreement appointing the depositary would unfortunately be a near impossible task, as Member States have each their own contract law and AIFs legal structures. We therefore support the drafting of a list of particulars to be included in the written agreement between the AIFM and the AIF's depositary. This approach was rightly followed in UCITS IV Level 2. This list should in particular reassert the core missions that the depositary may not waive and state that the depositary has a general obligation to act in the best interests of investors.

However, AFG believes that the following two points should be explicitly tackled in such agreements:

- 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.

Otherwise, if contracts are allowed to be flexible depending on the 'rapport de force' between the depositary and the AIFM, it would lead to a high heterogeneity which would ultimately be detrimental to a fair competition among AIFMs and to investors.

We support the rewording of item 2 in Box 76 which now reads "A description of the type of assets that will fall within the scope of the depositary's **safekeeping and oversight** functions (...)".

Furthermore, we think that the description of the type of assets under item 2 should also include a description of the geographic zones in which the AIF/AIFM plans to invest as this is essential information to allow the depositary to fulfil its obligations.

We also believe that in paragraph 9 modifications to offering documents are not relevant. We therefore suggest re-wording as follows:

"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".

Finally, we would like to amend paragraphs 7, 10 and 12 to cover only the relevant or necessary information in order to have a more realistic wording:

Para 7: ~~All~~ **the relevant information it needs**
Para 10: ~~all~~ **necessary information**
Para 12: ~~all~~ **necessary information**

Box 76 –Assessment of prudential regulation and supervision applicable to a depositary established in a third country

Box 76.1.a – We believe that it would be difficult, if not impossible, for an AIFM to assess whether an entity fulfils the criteria described by ESMA. For example, it is definitely not in a position to appreciate whether a foreign competent authority has adequate resources to fulfil its tasks. In this respect, it would be useful if ESMA provided further criteria that the foreign entity should fulfil, and, for each of those criteria, specified what entity - the AIFM or the authorities - is in charge of assessing whether or not they are met. In our view, it is for regulators to carry out this task.

Box 76.1.b - AFG welcomes the replacement of « equivalent » by « same effect as » (box 76) as well as the obligation for the Commission to adopt implementing acts stating that prudential regulation and supervision of a given third country jurisdiction have the same effect as Union law and are effectively enforced (explanatory text 7 p.146).

Indeed, in our opinion, the concept of "equivalence" is not defined precisely enough and it would be difficult to assess in practice whether some third country rules are "equivalent" to EU rules or not. Instead, we support the fact that ESMA sticks to the notion of "same effect as" used in the level 1 directive as it is *more precise, objective* and tangible. Otherwise, at level 2 the wording "equivalent" would in fact blur the meaning of "same effect" of level 1 – while level 2 measures are explicitly aimed at clarifying the level 1 principles. It is particularly important to avoid any discrepancy in interpretations from one Member State regulator to another.

Explanatory text 7 p.146

We support the proposal that the European Commission should adopt implementing acts stating that the prudential regulation and supervision of a given third country jurisdiction have the same effect as Union law and are effectively enforced. Indeed, it is in the common interest of investors, as well as a good way to reinforce harmonisation at EU level.

Indeed, in our opinion, it is not the AIFM's responsibility to assess whether the local regulatory framework of a third country has the same effect as those used in the EU. Rather, it is the role of the European competent authorities (i.e. the Commission or ESMA). Indeed, the level 1 directive states that the Commission should positively define which third countries meet the set criteria. Furthermore, the articulation of the role of the European competent authorities with that of the national competent authorities should be clarified.

Box 77 – Cash monitoring - General information requirements

We would like to that only the relevant or necessary information is covered and reword the first sentence of box 77 to be reworded as follows:

"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".

Regarding the second bullet point of box 77, we think that it ought to be clarified that the obligation to inform the depositary prior to the opening of new cash accounts does not imply that the depositary has any influence in the choice of the counterparties where the accounts are opened. Indeed, this is purely an investment decision for which the AIFM is the only responsible.

Third bullet point: this requirement to provide "… all information related to cash account …" is drafted in very broad terms and appears to be too extensive, given that the regulatory purpose (as described in paragraph 4 of explanatory text) is only to enable timely access by the depositary to the cash account. In line with the introductory paragraph in Box 75, the wording should therefore be amended to read as follows: "the depositary is provided with the necessary 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 the information regarding the AIF's cash accounts it needs to comply with its obligations and have a clear overview of all the AIF's cash flows".

AFG supports the removal by ESMA of the following obligation:

"Where the depositary does not receive this information, the AIFM will have been deemed not to have satisfied the requirements of Article 21 of the directive".

AFG also welcomes the introduction of the requirement for an information exchange agreement (box 77 third bullet point). Indeed, these agreements are already in place in practice and are compulsory under UCITS IV.

Box 78 – Proper monitoring of all AIF's cash flows

AFG supports the option chosen by ESMA regarding the monitoring of the AIF's cash flows (the alternative option proposed by ESMA in its consultation paper to make the depositary act as a central hub is too complicated and too costly to implement).

AFG also supports the obligation introduced by ESMA in its final advice for the depositary to check the consistency of its own records of cash positions with those of the AIFM (box 78.6).

Box 79 – Definition of financial instruments to be held in custody

AFG welcomes the definition of the financial instruments to be held in custody.

AFG also supports the statement that "any financial instruments received as collateral for the benefit of the AIF should be regarded as having been entrusted to the depositary for safekeeping".

Box 80 – Safekeeping duties related to financial instruments that can be held in custody

AFG welcomes the new obligation introduced by ESMA in its final advice for the depositary to "*introduce adequate organisational arrangements to minimise the risk of the loss or diminution of the financial instruments or of rights in connection with those financial instruments, as a result of misuse of the financial instruments, fraud, poor administration, inadequate record keeping or negligence*" (box 80.1.f).

However, we believe that the new obligation to "*apply [the depositary's safekeeping duties] on a look through basis to underlying assets held by financial and/or legal structures controlled directly or indirectly by the AIF or the AIFM on behalf of the AIF*" is too broad and would be too difficult to implement (box 80.3). Does it apply to master-feeders, to funds of funds (in the latter case, the provision would be difficult to implement if the relevant depositaries are not the same for the fund of funds and for all the underlying funds). The context in which this requirement applies and its objective should be specified.

It seems that the explanatory text page 160 (paragraph 25) gives power to the depositary over the AIFM which is presumed to have the intention to circumvent the Directive.

Box 82 – Reporting obligations for Prime brokers

AFG welcomes these requirements as they already are in place in practice.

Box 83 – Oversight duties – general requirements

AFG welcomes the clarification that controls by the depositary are performed ex post, at a second level, after the AIFM has carried out its own duties.

We suggest re-wording paragraph 3 as follows:

"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."

Box 85 – Clarification of the depositary's oversight duties – valuation of shares/units

3. 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.

AFG believes that the auditor, rather than the depositary, should be in charge with the AIFM to look at this. The depositary verifies the method of calculation, not the calculation itself.

Box 87 – Clarification of the depositary's oversight duties – settlement of transactions

We support the option chosen by ESMA regarding the duties related to the timely settlement of transactions.

Here we would like to highlight that, as AIFMs are not members of settment systems, they need to be informed by the depositary when in case of delays in the settlement of transactions. Furthermore, the depositary should be responsible for chasing compensation/payment ("contrepartie") if required.

Box 88 – Clarification of the depositary's oversight duties – income distribution

We would like to specify that these obligations are not exhaustive. We therefore suggest re-wording as follows:

"To fulfil its obligation pursuant to Article 21(9)(e), the depositary should in particular be required to":

1. "Ensure the net income calculation is applied in accordance with the AIF rules, instruments of incorporation and applicable national law".

AFG believes the auditor should be in charge of this.

3. "Check the completeness and accuracy of dividend payments and where relevant of the carried interest".

We would like to clarify that the depositary is responsible for checking that the dividend payments and where relevant the carried interest payments have been made according to the applicable rules and that is it not responsible for the actual calculations.

AFG supports the obligation for the AIFM to provide the depositary with all information on reserves expressed on the financial statements.

Box 89 - Due diligence requirements

AFG believes that the auditor of the depositary in its due diligence of the depositary should check that the depositary has duly fulfilled its obligations. In other words, the auditor report should specify that the depositary complied in practice with its obligations in line with Directive provisions, in particular in terms of due diligence on its sub-custodians.

2 - AFG welcomes the provision that the due diligence requirements should apply mutatis mutandis to further sub delegations by the sub custodian.

5 - AFG welcomes the introduction of the new obligation for the depositary to notify the AIFM where it becomes aware that the segregation of asset is not or is no longer sufficient to ensure protection form insolvency of a sub custodian in a specific jurisdiction. However, ESMA does not provide for cases whereby the depositary actually notifies the AIFM of such situation. We would therefore welcome a provision specifying that such notification does not affect the depositary's responsibility (i.e. as long as the sub custodian is on the list made by the depositary, the latter remains liable).

Only when the depositary removes the relevant subcustodian from its subcustody network – after notifying the AIFM - can he be discharged of its responsibility.

AFG also welcomes the obligation to include measures on the termination of the contract with sub-custodians.

Box 90 – Segregation

1.a - AFG strongly supports the obligation introduced by ESMA in its final advice for third parties – as well as for depositaries - to segregate the assets in 3 parts as follows:

"distinguish assets safekept for the depositary on behalf of its clients from its own assets and (1) its own assets and the assets of its clients and (2) the assets held by the depositary for its own account and the assets held for the depositary's clients (3) assets held for AIFs from assets held for any other clients" (box 90.1.a).

We support such segregation for the following reasons:

- contrary to direct clients that benefit from an individual compensation scheme, AIFs do not benefit from it and therefore should be protected in another way

- contrary to other clients which can open accounts within several custodians, funds (either AIFs or UCITS) cannot open accounts in several depositaries. We agree with this requirement, but it means that the risk related to the depositary's bankruptcy cannot be split among several depositaries

Therefore, in case of bankruptcy of the depositary or sub-custodian, all assets – including the cash - belonging to AIFs (or funds at large) should be rapidly transferred to another depositary (or sub-custodian) – thus acting in the best interest of AIF clients and complying with AIFM fiduciary duties vis-à-vis its clients, as the continuity of the active management of the AIF will be guaranteed, without having to wait for the court resolution of the depositary (or sub-custodian) bankruptcy.

This segregation among clients' assets in two parts was successfully tested in France in the 1990, with the bankruptcy of the Pallas Stern Bank: all the assets belonging to funds were transferred to other custodians in only a few weeks, and therefore the active management of these funds was preserved - without having to wait for the final settlement of the bankruptcy.

In addition, from a technical perspective, there is no difficulty for custodians to set such segregation among clients' assets between funds' assets and other clients' assets, as today this segregation has gone even further, at individual level in many cases:

- for legal reasons, many countries out of Europe already require today a segregation of assets – including both cash and Financial Instruments - which goes even beyond what we are asking for: while we are only asking for separating clients' assets in two omnibus accounts, i.e. funds' assets on the one hand and other clients' asset on the other hand, many countries – with big fund industries – require a segregation fund by fund throughout the whole chain, from the depositary to the CSD. Such a list of countries includes China, Brazil, Chile, India, Korea, Taiwan for instance. Some of these countries have a significant fund industry. Considering that investment funds' assets in some non EU countries are identified and returned at individual level, it would be paradoxical if Europe did not require at least a segregation in three parts at the level of depositary and sub-custodians, i.e. depositary's (and sub-custodian's) own assets, client funds' assets and other clients' assets;

- in practice, when a big fund client asks a depositary to benefit from a single account in the whole depositary and sub-custodian chain, it gets it if it is big enough to impose it. It clearly shows that technically segregation, even until at individual level, is possible.

Of course, it would imply that, when entering the relationship with the AIFM, depositaries provide the AIFM with a list of countries in which such segregation can be guaranteed. If the legislation in some countries would not allow for such segregation, then this obligation would not apply – and there should be a discharge of responsibility of the depositaries if the AIFM decides to invest in such countries however.

We believe that the obligation of restitution of cash should be made clear (in addition to financial assets held in custody).

1.f - AFG also welcomes the obligation to introduce adequate organisational arrangements to minimise the risk of the loss or diminution of the financial instruments […]".

Box 91 - Definition of loss

We believe that the "permanent" nature of a situation is very difficult too assess in practice. How long does one have to wait until a situation can be considered as permanent?

We suggest rewording paragraph 1.b and 1.c and the second subparagraph of paragraph 2 as follows:

"the AIF has been ~~permanently~~ deprived of its right of ownership over the financial instruments unless it is for a limited period of time"

"the AIF is ~~permanently~~ unable to directly or indirectly dispose of the financial instruments unless it is for a limited period of time"

"Where an AIF is ~~permanently~~ deprived of its right of ownership in respect of a particular instrument unless it is for a limited period of time"

We however do support the removal of the reference to the end of the insolvency proceedings in determining the loss of financial instruments.

Box 91.1.c – we propose to replace "unable" by "prevented".

Box 91.2 – similarly to the comments above, we ask for the deletion of the adverbs "certainty" and "effectively" in the last sub-paragraph, as such mentions might be interpreted as requiring waiting for the end of all legal procedures before allowing for action. We think that instead, and as mentioned right above for Box 91.1.c, the triggering event should be when the AIF is prevented from permanently directly or indirectly disposing of the financial instruments.

In addition, AFG believes that the depositary, not the AIFM, should be required to monitor the proceedings and determine whether the assets are effectively lost. Indeed, the AIFM does not have any relationship with the sub-custodian. The AIFM is the client of the depositary and in turn of the sub-custodian.

"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~~ custodian on behalf of 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."

Box 92 – Definition of event beyond the depositary's reasonable control

We support the approach that an event linked to the sub custodian should be considered as internal.

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".

This requirement should also apply to any sub-custodian.

3.a - We support the introduction of the wording shown in bold below:

"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 event ***it could reasonably identify*** *which it considers may result in a loss of a financial instrument held in custody".*

"The above described conditions will apply to the delegate when the depositary has contractually transferred its liability to a sub-custodian".

AFG believes that this should be deleted as it is confusing. The contract will define the obligations of the sub-custodian anyway.

Box 93 – Objective reasons for the depositary to contract a discharge

AFG welcomes the option chosen by ESMA in its final advice. Indeed, the outcome of the alternative option proposed by ESMA in its consultation paper would depend on the weight of the AIFM in its relationship with the depositary, which would not be in favour of small sized AIFMs but in favour of large sized AIFMs.

We also support the step by step approach proposed in its final advice.

2 - AFG furthermore supports the clarification that the cases whereby the AIFM considers that it is in the best interest of the AIF and its investors for the depositary to discharge its liability and has notified the depositary of that assessment in writing should be considered as objective reasons for the depositary to contract a discharge.

Boxes 94 to 101 - Leverage

- We believe that the number of methods to be used to calculate the exposure of the AIF should be proportionate to the size and type of the AIF, i.e. to the type of assets in its portfolio and the purpose of the leverage. For instance, the use of a single

methodology would reduce the burden on asset management companies that manage both UCITS and "UCITS like" funds. In other words, **the choice of the calculation method should be up to the manager, which will be in a position to pick for each AIF it manages the calculation method most suitable to the profile of the AIF.**

- **The methods to be used should be in line with the methods applicable to UCITS (i.e. commitment or VaR, at the choice of the AIFM**). Indeed, most AIFs are "UCITS like funds". For instance in France, nationally regulated "general purpose" funds represent an AUM of EUR 560 Billion (French investment funds in the scope of the AIFMD total AUM = EUR 712 billion). The same proportion is true throughout Europe. However, if an AIF uses borrowing (which is not allowed for UCITS), it should of course be taken into account in the calculation.

- AFG reiterates that the gross method of calculating the leverage of an AIF is highly misleading for investors (please see above).

- AFG requests the Commission to clarify the requirement proposed by ESMA in its final advice relating to the exposure contained in structures involving third parties controlled by the AIFM as we do not understand such requirement (box 94).

- Regarding funds of funds, AFG proposes to follow a similar approach to that applied to private equity funds i.e. not to take into account the leverage at the level of the underlying funds.

  Indeed, it would be very difficult in practice to aggregate the leverage of each underlying hedge fund.

Box 107 – Remuneration disclosure

Following the publication of ESMA final advice on possible Level 2 measures of the AIFMD, AFG does not have any specific remarks on the requirements relating to the disclosure of remunerations. However, as ESMA is to develop Level 3 guidelines on this matter, we may make further comments at a later stage.

Box 109 - Regular Disclosure to Investors

1.d - "details of changes in any service providers"

We believe that these details should be disclosed in relation to depositaries and auditors only, as it would be very difficult in practice to do so in relation to all service providers.

Box 110 – Format and content of reporting to competent authorities

Regarding the reporting to competent authorities, we believe that its frequency should not depend on the size of the AIFM. Rather, it should be adjusted to the type of funds managed by the AIFM.

We believe that a disclosure on a quarterly basis would be too burdensome and above all not relevant. Indeed, a large part of AIFs are "UCITS like" funds for which a quarterly reporting

would generate significant initial and ongoing costs. Moreover, detailed quarterly reporting would certainly exceed what is necessary to monitor systemic risk.

This would certainly be an additional burden especially for small-sized AIFMs and would therefore contradict the general principle of proportionality. For example, one of our members estimates that the cost of implementing a quarterly reporting would be of one person over the first year (in particular in order to set in place the required processes and procedures) and half a person the following years.

We think that an annual basis would be more appropriate. Additionally, we urge the Commission to apply the principle of proportionality based on the size of the AIFM and the types of AIFs it manages.

In any case, from a systemic risk point of view, the thresholds are too low. Only large AIFMs should be subject to a quarterly disclosure (such a frequent disclosure is not relevant for smaller AIFMs).

2 - We welcome the extension of the period allowed for funds of funds to report the requested information.

Box 111 - Use of Leverage on a 'Substantial Basis'

We believe that the reference to **the gross calculation method should be removed and the choice of the calculation method left up to the AIFM (please refer to our previous comments of the methods of calculating the exposure of an AIF) by analogy with the UCITS Directive.**

In our opinion, the criteria set out in order to assess whether leverage is employed on a substantial basis are highly judgmental and subjective and could be interpreted very differently by competent authorities and AIFMs. We therefore wonder whether the proposed definition will lead to a consistent approach to leverage. This is particularly the case as the list is noted as being "non exhaustive".

Moreover, we believe that to perform the assessment required under the points d) to f), the AIFM would have to consider consolidated information on the markets and information about investees/counterparties that are not under its control or accessible to it but rather only to the regulators. These points create an obligation that is difficult to discharge effectively.

Box 112 – Cooperation arrangements between EU and non EU competent authorities

We agree that it would be beneficial if ESMA established the detailed content of the cooperation arrangements. We therefore urge the Commission to make binding paragraph 5 of the explanatory text p.14 of ESMA consultation paper. We also support the development of a template agreement by ESMA in order to set minimum requirements; we therefore urge the Commission to make binding paragraph 12 of the explanatory text p.15 of ESMA consultation paper. In our opinion, ESMA should set templates based on the IOSCO multilateral memorandum of understanding of May 2002 for both the arrangements relating to delegations to entities in third countries and to cooperation between EU and third country competent authorities, so that consistency is ensured and the burden of the authorities reduced. However, the IOSCO MMoU should be considered as a minimum.

In addition, we believe that it would be useful to publish such arrangements on the website of ESMA and of the relevant national competent authorities.

1.d - We welcome the new requirements introduced by ESMA in its final advice on the content of the cooperation arrangements between competent authorities relating to on-site inspections. However, we suggest that ESMA should play a more active role in such on-site inspections, for instance ESMA should be involved in - or perform itself - such inspections. This would allow for more harmonisation at EU level and a more consistent implementation of the Directive.

We would like to raise the Commission's attention on the fact that cooperation arrangements should be complemented by arrangements on the reciprocity of marketing activities.

Box 113 – Member State of Reference

In our opinion, there should be ex post checks by ESMA that the Member State of Reference actually meets the criteria set by the level 1 Directive and has been properly determined. The Member State of Reference could be for example assessed also with regards to the reciprocal marketing agreements between itself and the relevant third country.

5 – We believe that the proposed one week deadline is too short. One month would be better, in order to let a reasonable time to all relevant competent authorities to assess the relevant case.

We welcome the new obligation introduced by ESMA in its final advice for the non EU AIFM in case of a conflict regarding the determination of the Member State of reference (box 113.7).

"In the event that the requesting non-EU AIFM is not informed in writing of the decision within the deadlines provided for under art. 37(4), the requesting non-EU AIFM should inform in writing all the authorities originally contacted about its choice of the Member State of reference".