



European Securities and
Markets Authority

Final report

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



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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. This paper sets out ESMA's technical advice on the content of the implementing measures² for the AIFMD.

Contents

This paper sets out ESMA's advice for implementing measures regarding the issues identified in the European Commission's request. The formal advice is contained in the boxes in Sections III to IX of the paper, while further commentary and explanation is provided in the explanatory text. A cost-benefit analysis of ESMA's advice can be found in Annex II, followed in Annex III by the formal advice provided by ESMA's Securities and Markets Stakeholder Group. Feedback on the public consultations is set out in Annex IV.

General provisions, authorisation and operating conditions

This section includes 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.

Depositories

This section sets out ESMA's advice on the contract evidencing appointment of the depository, general criteria for assessing the effective prudential regulation and supervision of third countries, depository 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.

Supervision

This part of the advice focuses on the co-operation arrangements to be put in place with third country authorities pursuant to Chapter VII of the Directive.

Next steps

The European Commission asked ESMA to submit its advice by 16 November 2011. The Commission will now work to prepare the implementing measures in light of ESMA's advice.

II. Introduction and background

1. The European Commission's proposal for a Directive on Alternative Investment Fund Managers was published in April 2009³. 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 paper sets out ESMA's advice on Parts I to IV of the Commission's request. A summary of the issues covered under each part is included 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 website⁵). The feedback to the call for evidence and additional discussions with external stakeholders were taken into account in the development of ESMA's draft advice that was published for consultation in two stages. The first stage was the publication of a consultation paper (CP) in July covering the first three parts of the Commission's request (ESMA/2011/209)⁶, followed by a second CP in August that addressed Part IV of the request (ESMA/2011/270).⁷ ESMA received 104 and 49 responses to the two CPs respectively (the non-confidential responses are available on ESMA's website⁸). Open hearings on the two consultations were held at the ESMA premises in Paris; the first on Friday 2 September, the second on Monday 26 September.
4. The final text of the AIFMD, which will take effect in July 2013, was published in the Official Journal on 1 July 2011.⁹ All references to articles of the Directive in the advice relate to that version.

Part I: General provisions, authorisation and operating conditions

Article 3 exemptions

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://www.esma.europa.eu/popup2.php?id=7625>

⁷ <http://www.esma.europa.eu/popup2.php?id=7702> This paper also covered third country aspects of the requirements on delegation and depositaries.

⁸ <http://www.esma.europa.eu/index.php?page=responses&id=185> and

<http://www.esma.europa.eu/index.php?page=responses&id=188>

⁹ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:0073:EN:PDF>

5. This section of the 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 discussion paper on policy orientations in April (ESMA/2011/121).¹⁰ The feedback in the 17 responses received¹¹ was taken into account in the refinement of the proposals in the relevant part of the CP published in July. ESMA's advice in this area covers the method to be used by AIFMs to calculate the total value of assets under management as well as the information to be provided as part of the registration process and details on the opt-in procedure for AIFMs which seek authorisation.

General operating conditions

6. The overall approach taken to the 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

7. Under this part of the advice, ESMA was 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 (PII). On the calculation of additional own funds, the advice sets out a methodology based on the variable assets under management (AuM). The advice also includes the possibility for AIFMs to combine additional own funds and PII subject to certain conditions, as well as clarifying that a combination of several PII policies is permitted in situations where only PII is taken out (i.e. there is no combination of own funds and PII) and provided that all the risks are covered.

General principles and organisational requirements

8. ESMA was 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 asset in which they are invested. However, as UCITS provisions are tailored for open-ended investment funds that generally invest in financial instruments, the advice provides adjustments or exemptions for those AIFs that are not open-ended and invest in assets other than financial instruments. Regarding the organisational requirements, ESMA's advice is 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.

¹⁰ <http://www.esma.europa.eu/popup2.php?id=7547>

¹¹ The non-confidential responses are available here: <http://www.esma.europa.eu/index.php?page=responses&id=181>

Conflicts of interest

9. ESMA was 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 was 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. With regard to the description of the types of conflict of interest, ESMA took into account that the UCITS Directive 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'.¹²

Risk management

10. 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 risk.

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 advice with limited tailoring.

Liquidity management

11. In line with the request from the Commission, the following issues are addressed in the 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 advice. Regard was also had to industry guidance and good practice standards.

¹² <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD341.pdf>

Investment in securitisation positions

12. ESMA was 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). The objective of these provisions is to ensure cross-sectoral consistency and remove misalignment between the interests 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

13. ESMA was 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.
14. 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 the diverse types of asset in which an AIF may invest.
15. 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

16. The Commission's request invited 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 a general principle 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, supplemented by an indicative, non-exhaustive list of criteria to be used when making the assessment.
17. 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 as part of 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.

18. The advice also addresses the issue of delegation of portfolio management or risk management to a third-country undertaking. A number of conditions would have to be satisfied in order for such a delegation to take place, in particular the existence of a written agreement 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. The written agreement should cover such areas as on-site inspections, exchange of information and the existence of sufficiently dissuasive enforcement actions.
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. General criteria for assessing the effective prudential regulation and supervision of third countries
- iii. The depositary's duties
- iv. The depositary's liability regime

Appointment of a depositary

21. In line with the request from the Commission, the advice on this point sets out ESMA's views 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.

General criteria for assessing the effective prudential regulation and supervision of third countries

23. Article 21(6) of the Directive sets out the conditions under which a depositary established in a third country can be appointed, one of which is that the depositary is subject to 'effective prudential regulation, including minimum capital requirements, and supervision which have the same effect as Union law and are effectively enforced.' ESMA was requested to develop criteria for assessing whether the relevant third country framework is to the same effect as the provisions laid down in European law. ESMA's advice covers such elements as the capital requirements that should be in place, the rules on operating conditions and the existence of sufficiently dissuasive enforcement actions in case of breaches.

Duties of the depositary

24. 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

25. 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 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 defined as all assets not covered by custody.

Oversight function

26. 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 advice aims to clarify each task.

Cash monitoring

27. The 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.

28. Regarding the tasks which would be expected of a depositary when implementing its cash monitoring obligations, the advice 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.

29. 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's advice clarifies 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

30. 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 was 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

31. 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 asked ESMA to clarify what the specific requirements should be to make sure the sub-custodian effectively meets that obligation. The 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

32. 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 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 all 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

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

Leverage

34. Three aspects related to leverage are addressed in the 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.

35. 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/10-788¹³) was 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.

¹³ <http://www.esma.europa.eu/popup2.php?id=7000>

36. The following approach is set out in the advice:

- the ‘exposure of an AIF’ is to be calculated by an AIFM 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 and after notification to its competent authority;
- the overall leverage of an AIF can be expressed as a ratio between the exposure of an AIF and its net asset value.

37. The Commission’s request sought 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 stability and integrity of the financial system. In this regard, the following elements are set out in the 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

38. 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

39. This part of the advice covers the implementing measures on co-operation arrangements with third country authorities and the determination of the Member State of reference for non-EU AIFMs. On



the former issue, ESMA has based its approach as much as possible on existing international standards while taking into account the particularities of the AIFMD. On the issue of the Member State of reference, the advice identifies further criteria that could be taken into account in the case of a conflict between several competent authorities, such as the Member State where advertisements are most visible and frequent.

Next steps

40. ESMA will now take forward its work on the other subordinate measures foreseen by the Directive (guidelines and regulatory and implementing technical standards), prioritising those measures which should be finalised in parallel with the adoption of the implementing measures by the European Commission. ESMA has also identified a number of areas in which it considers it appropriate to develop guidelines in order to foster a harmonised implementation of the new framework.

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 was 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. Concerning the method to calculate the total value of assets under management, ESMA proposed in the consultation paper, that it should be carried out at least annually using the latest net asset value. Many respondents to the consultation expressed some concerns that the net asset value may not be the most appropriate method and asked for more flexibility.
5. In light of the comments received, ESMA reconsidered its position and recommends that the calculation of the total value of assets under management should be performed at least annually using the latest asset value calculation. However, ESMA believes that derivatives instruments should not be considered at their market value but converted into their equivalent position in the underlying asset of that derivative. ESMA recommends that the methodologies to be used should be the same as those developed by CESR in the guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS.
6. ESMA was 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. In the initial public consultation, 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.

7. 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 consulted on the basis that AIFMs should 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. This proposal was supported by respondents to the second consultation and therefore ESMA did not modify the approach.
8. ESMA was 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 was 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.

9. 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. Therefore, ESMA recommends that AIFMs should implement and apply procedures on an on-going basis in order to monitor their total assets under management on a continuous basis to assess whether they can continue to avail of the exemption while acknowledging that 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 and changes in market value of assets since the last threshold calculation.

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 as defined in the Directive, 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. 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.
3. The total value of the assets under management should be calculated at least annually using the latest available asset value calculation and should include assets acquired through leverage for each AIF. The latest available 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 frequency of the asset value calculation of the AIF under management.

4. 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 to these AIFs. 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 AIFM's assets under management subject to appropriate adjustments for leveraged exposure to this compartment.
5. AIFMs should implement and apply procedures on on-going basis to monitor the value of total assets under management, including subscription and redemption activity or where applicable capital draw downs, distributions and the value of the assets invested in for each AIF and should where necessary, taking into account proximity to the threshold and anticipated subscription and redemption activity, recalculate the value of total assets under management
6. 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. In the affirmative, 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.
7. 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

10. The AIFM should include the assets under management of each AIF for which it would be the appointed AIFM. UCITS managed by the AIFM and 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 are excluded

from the calculation of the total value of assets under management. The total value of assets under management for each AIFM should be calculated at least annually. While it is recognised that some of the 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 asset value calculations must be carried out within 12 months of the calculation of the total value of assets under management.

11. 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. For example, ESMA considers that interest rate hedging positions in private equity funds should be excluded.
12. ESMA's advice gives 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; therefore, ESMA recommends that each derivative position should be converted into its equivalent position in the underlying assets of that derivative for the purpose of the calculation of the total value of assets under management.
13. 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.
14. In monitoring the total value of assets under management the AIFM should take into account subscription and redemption activity or, where applicable, capital drawdowns, capital distributions and the value of the assets invested in for each AIF. The AIFM should also consider the types of AIF under management and the different classes of asset invested in to assess whether the threshold may be exceeded and/or whether an additional calculation is needed. In assessing whether an additional calculation is necessary, the AIFM should consider how soon the next annual calculation will be carried out.
15. 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.
16. 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.

17. 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.
18. 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 on request.

III.II. 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

19. ESMA was 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 was 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 out in Article 3(3). To that end, ESMA was requested to specify the content, the format, and modalities of the transmission of the information to be provided to competent authorities.
20. 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.

21. 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.

22. The provisions in Box 2 should be read alongside those of Box 110, 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.

23. Respondents to the public consultation disagreed with the requirement for AIFMs to report information under Article 3(3)(d) on a quarterly basis. According to the majority of stakeholders, this requirement would be overly burdensome and inappropriate for AIFMs not subject to the AIFMD. ESMA took on board this comment and recommends that this information should be reported at least annually. This requirement is consistent with the approach taken for provisions on reporting obligations to competent authorities under Article 24 which are developed further in Box 110 of the advice.

Box 2

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 management.
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 Article 3 should be provided 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.

Explanatory Text

24. 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.
25. 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.

III.III. 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

26. ESMA was 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 was to consider whether there are specific reasons not to use the same procedure that applies to AIFMs that do not benefit from this exemption
27. 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.
28. 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.

29. As the feedback from the consultation was generally supportive, ESMA did not modify the advice for on opt-in procedures.

Box 3

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 4

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 which 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

30. AIFMs which are authorised under the Directive and subsequently 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 tranching, 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 was requested to provide the Commission with a description of the types of risk arising from professional negligence. Furthermore, ESMA was 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 consultation expressed a general concern on the implementing measures relating to the additional own funds and the professional indemnity insurance requirements: on the one hand, the inappropriateness of the additional own funds rules for internally managed AIFs was highlighted; on the other hand, respondents (including representatives of the insurance sector) claimed that there would likely be an inadequate amount of insurance capacity to fulfil the demand for professional indemnity insurance that will arise as a consequence of the new rules.
3. In order to cope with these issues, several respondents called for the introduction of certain amendments aimed at tempering the effects that the new rules may have both on the asset management industry and the insurance sector: they asked for the introduction of the possibility to have a combination of additional own funds and professional indemnity insurance, on one side, and of a cap for the additional own funds required under article 9(7) of the AIFMD, on the other side. Furthermore, the request to clarify that a combination of several professional indemnity insurance policies is possible was also put forward.
4. The large majority of respondents preferred a rule for calculating additional own funds to cover potential liability risks which is based on the variable assets under management; indeed, they were of the view that there is no logic link between the liability risk and the income of an AIFM, on which the alternative option set out in the consultation was based.

5. ESMA saw merit in the requests for introducing the possibility to have a combination of additional own funds and professional indemnity insurance and clarifying that a combination of several professional indemnity insurance policies is possible (except in case of combination of additional own funds and professional indemnity insurance, in which case only a single professional indemnity insurance policy shall be concluded). However, ESMA did not take on board the request of introducing a cap for the additional own funds required under article 9(7) of the AIFMD since this would have resulted in an unjustified advantage to larger AIFMs.
6. ESMA did not agree with the request to exclude the losses arising from entities providing services to the AIFM under a delegation agreement since according to Article 20(3) of the AIFMD, the liability of the AIFM shall not be affected by the fact that it has delegated functions to a third party, or by any further sub-delegation. However, ESMA agreed on clarifying that the liability of the AIFM shall be limited to the AIFM's directors, officers or staff or third parties for whom the AIFM has vicarious liability.
7. Finally, ESMA retained the rule for calculating additional own funds to cover potential liability risks which is based on the variable assets under management. This rule 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 additional own funds referred to in those Articles. It is therefore based on an existing method and does not introduce a new one. It is also based on the assumption that liability risks rise with the value of the portfolios of AIFs managed by the AIFM.

1. Description of potential risks

Box 5

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 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 the AIFM's directors, officers or staff or third parties for whom the AIFM has vicarious liability
- 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 (except for internally-managed AIFs)
- iv. failure by the senior management to establish, implement and maintain appropriate procedures to prevent dishonest, fraudulent or malicious acts by the AIFM's directors, officers or staff or third parties for whom the AIFM has vicarious liability
- v. improper valuation of assets and calculation of unit/share prices

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

Losses arising from negligent failure resulting in the disruption of business or system failures, from failed transaction processing or process management

Explanatory Text

8. 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 risks of losses arising from the professional activities of the AIFM for which the AIFM has legal responsibility.
9. Paragraph 2 of Box 5 classifies potential loss events that may lead to liabilities of the AIFM and thus should be considered as liability risks. The two broad categories are followed by more detailed explanations on what should be considered. However, the listed explanations are not exhaustive.
10. The first 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 for which the AIFM is responsible, making misrepresentations, breaching its duty of care or breaching its duty of confidentiality. Other liabilities that potentially arise are particularly the negligent breach by the AIFM of the AIF rules that would also include the breach of the investment mandate or the failure to prevent by means of adequate internal control systems fraudulent behaviour within the AIFM’s organisation. Moreover, negligently carrying out due diligence would also be considered a 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.

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

Box 6

Qualitative Requirements (based on Annex X Part 3 Directive 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 a 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, where 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 risks arising from professional negligence are covered by own funds (calculated according to Box 7) or professional indemnity insurance (calculated according to Box 8) or a combination of both methods (calculated according to Box 9) at all times.

Explanatory Text

11. Box 6 requires the implementation of appropriate internal control mechanisms 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 ensures 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.
12. The risk management policies and procedures should also include the building up of an internal loss database as the 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.
13. The requirements in Box 6 aim at a risk-based approach. The AIFM itself is responsible for maintaining 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 or by a combination of both methods. If the AIFM identifies a shortfall between the own funds calculated according to Box 7 or the insurance cover according to Box 8 and its liability risk, the AIFM must compensate this difference by maintaining additional own funds or insurance cover with the assessed amount.

Quantitative Requirements

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.
2. The own funds requirement is recalculated and, if necessary, adjusted at the end of each financial year.
3. 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 6 and a minimum historical observation period of three years – that liability risk according to Box 5 is adequately captured. Conversely, the competent authority may raise the additional own funds requirements if they are not sufficient to capture liability risk arising from professional negligence.

Explanatory Text

14. This Box provides for additional quantitative minimum requirements. Paragraph 1 sets out the calculation methodology for the minimum amount of additional own funds.

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

$$0.0001 \times \text{AuM},$$

where AuM are the assets under management i.e. the value of the portfolios of AIF managed by the AIFM.

16. The calculation method is solely based on the variable assets under management (AuM). This method 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. The method is also based on the assumption that liability risks rise with the value of the portfolios of AIFs managed by the AIFM.

17. The amounts are recalculated each financial year and adjustments to own funds have to be made according to the recalculated amounts. In order to incentivise better operational risk management, the competent authority of the home member state of the AIFM may allow a lower percentage (but not less than 0.008% of AuM), if the AIFM can demonstrate that the lower amount adequately covers the liabilities based on historical data. This encourages the implementation of adequate operational risk management systems according to Box 6. In contrast, historical loss data may give rise to higher capital requirements than the amount calculated according to paragraph 1. However, the figure calculated according to paragraph 1 is the minimum amount. In cases of higher liability risk exposures, the AIFM is not considered to comply with Box 6 if only the minimum amount according to paragraph 1 is captured, since paragraph 8 of Box 6 requires that the AIFM must cover its liability risk exposure by sufficient

own funds. The competent authorities may increase the required additional own funds where they deem it necessary to cover professional liability risk.

Box 8

Professional Indemnity Insurance

1. As an alternative to the requirements in Box 7 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's directors, officers or staff or third parties for whom the AIFM has vicarious liability;
 - (c) The liability risks listed in Box 5 are covered;
 - (d) Any defined excess is covered by own funds which are in addition to the own funds to be provided, where applicable, according to Article 9(3) and 9(7)(a) of Directive 2011/61/EU;
 - (e) The insurance is taken out from an insurance undertaking authorised to transact professional indemnity insurance, which is subject to prudential regulation and ongoing supervision. In case of third country insurance undertakings, the AIFM has to demonstrate to the competent authority, that those requirements are fulfilled and that the insurance undertaking has sufficient financial strength with regard to the claims paying ability;
 - (f) The insurance is provided by a third party entity;
2. The coverage of the insurance per claim must be adequate for the individual AIFM's 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's liability risk. The minimum coverage of the insurance for all claims in aggregate per year must at least equal the higher 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 7.

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

18. Box 8 sets out the requirements with which the professional indemnity insurance (PII) has to comply to be deemed equivalent coverage compared to own funds in Box 7.
19. Box 8 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 adequate due diligence, assess the financial strength of non-EU regulated insurance undertakings as sufficient. There is a presumption of solvency for EU regulated insurance undertakings.
20. Box 8, paragraphs 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 risks AIFMs face. Nevertheless, ESMA has fixed 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 paragraphs 2 (a) and (b) and, respectively, 3 (a) – (c).
21. Paragraphs 2 (a) and 3 (a) also reflect Article 9(3) of the AIFMD and provide for a minimum amount in relation to the assets under management of the AIFM i.e. are size dependent.
22. In line with the requirement in Article 7(b) of 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 8 paragraph 2 (b) and 3 (b) imposes fixed minimum coverage. However, minimum coverage amounts are higher since a direct comparison with the aforementioned MiFID firms is not appropriate, particularly as those firms are not required to maintain additional own funds and according to AIFMD, PII and own funds are considered equivalent. Paragraph 3 (c) is the link to the amounts calculated according to Box 7. Overall, the minimum coverage may be higher than the amounts calculated as own funds according to Box 7. This can be explained by higher uncertainty and risk in relation to the insurance coverage (e.g. higher legal and contractual uncertainty, possible insolvency of the insurer) and aims to compensate this disadvantage.
23. ESMA considers that a combination of several PII policies is possible, provided that overall all the liability risks listed in Box 5 are covered and the minimum coverage described in Box 8 paragraphs 2 and 3 is ensured.

Box 9

Rules for the combination of additional own funds and Professional Indemnity Insurance

1. As an alternative to the requirements in Box 7 paragraph 1 regarding additional own funds and in

Box 8 regarding the professional indemnity insurance, the AIFM may cover its liability risk arising from professional negligence by a combination of additional own funds and professional indemnity insurance.

2. In case the AIFM chooses to cover its liability by a combination of additional own funds and professional indemnity insurance, the AIFM shall determine the respective amounts of additional own funds and professional liability insurance according to the following procedure:
 - (a) The AIFM shall determine the amount of additional own funds which would be required according to Box 7 paragraph 1;
 - (b) The AIFM shall determine which percentage of the amount determined according to paragraph 2(a) is to be covered by additional own funds, provided that such percentage is not less than 10%;
 - (c) For the percentage of the amount determined according to paragraph 2(a) which is not to be covered by additional own funds, the AIFM shall:
 - i) take out and maintain at all times a single professional indemnity insurance policy complying with the requirements of Box 8 paragraph 1;
 - ii) ensure that the coverage of the insurance per claim and for claims in aggregate per year is adequate for the individual AIFM's liability risk and that the minimum coverage of the insurance for each claim and for all claims in aggregate per year at least equals the higher of the amounts indicated in Box 8 paragraphs 2(a) and (b) and 3(a) to (c), respectively, modified as follows:
 - the percentages under Box 8 paragraphs 2(a) and 3(a) shall be reduced on a pro rata basis for a percentage equivalent to the percentage determined according to paragraph 2(b);
 - the amounts under Box 8 paragraphs 2(b) and 3(b) and (c) shall be reduced on a pro rata basis for a percentage equivalent to the percentage determined according to paragraph 2(b).
3. The AIFM shall notify the competent authority of its home Member State of the respective amounts of additional own funds and professional indemnity insurance calculated according to paragraph 2. The competent authority of the home Member State of the AIFM may require modification of the amounts of additional own funds and professional indemnity insurance as calculated by the AIFM according to paragraph 2 if they deem these insufficient or inadequate to capture liability risks arising from professional negligence. In such a case, the competent authority may require the AIFM to provide additional amounts of own funds within the limits of Box 7 and/or additional coverage of professional indemnity insurance within the limits of Box 8.
4. The AIFM should review the amounts of additional own funds and professional indemnity insurance determined according to paragraph 2 at least once a year and in the event of any change which affects compliance of the professional indemnity insurance policy with the requirements of Box 8 paragraph 1.

Explanatory Text

24.Box 9 provides for the possibility to use a combination of both additional own funds and professional indemnity insurance in order to ensure adequate flexibility, in particular, in relation to internally managed AIFs for which the additional own funds requirement may be onerous and disproportionate.

25.According to paragraph 2, the respective amounts of additional own funds and professional indemnity insurance shall be calculated following a three-step procedure:

- (a) firstly, the AIFM shall determine the amount of additional own funds which would be required in Box 7 paragraph 1;
- (b) secondly, the AIFM shall determine which percentage of the amount determined according to Box 9 paragraph 1(a) is to be covered by additional own funds (such percentage shall not be less than 10%); and
- (c) thirdly, the AIFM shall determine the amount of additional own funds which is to be adapted to the professional indemnity insurance requirements according to the rules set out in Box 9 paragraph 2(c).

26.For example, if the value of the portfolios of AIF managed by the AIFM are equivalent to EUR 1 billion and the AIFM wanted to cover 50% of its liability by providing additional own funds and 50% by entering into a PII policy, it should calculate the respective amounts as follows:

- (i) The AIFM should provide €500,000 of additional own funds (i.e. 50% of 0.01% of the value of the portfolios of AIF managed by the AIFM);
- (ii) The AIFM should enter into a PII policy complying with the requirements of Box 8 paragraph 1 which must have the following characteristics:
 - (a) the coverage of the insurance per claim and for claims in aggregate per year is adequate for the individual AIFM liability risk;
 - (b) the minimum coverage of the insurance for each claim must at least equal €2,812,500
→ i.e. the higher of the following amounts:
 - 50% of 0.75 % of the amount by which the value of the portfolios of the AIFM exceeds €250 million (i.e. 0.375% of €1 billion – €250 million = 0.375% of €750 million = €2,812,500), up to a maximum of €20 million;
 - €1 million (i.e. 50% of €2 million);
 - (c) the minimum coverage of the insurance for all claims in aggregate per year must at least equal €3,750,000
→ i.e. the higher of the following amounts:

- 50% of 1 % of the amount by which the value of the portfolios of the AIFM exceeds €250 million (i.e. 0.5% of €1 billion – €250 million = 0.5% of €750 million = €3,750,000), up to a maximum of €25 million;
- €1.25 million (i.e. 50% of €2,5 million);
- €500,000 (i.e. 50% of the amount calculated according to Box 7).

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 was 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 consultation 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. 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 consultation 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, the 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 AIFMs 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 using 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. AIFMs should apply appropriate policies and procedures for preventing malpractices that might reasonably be expected to affect the stability and integrity of the market.
2. AIFMs 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) AIFMs should take appropriate measures to avoid malpractices that might reasonably be expected to affect the stability and integrity of the market. Examples of such malpractices are market timing and late trading. Furthermore, AIFMs should establish appropriate procedures to ensure efficiency in the management of the AIF 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. AIFMs 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. AIFMs should ensure that they have adequate knowledge and understanding of the assets in which the AIF is invested.
3. AIFMs 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 with which AIFMs have to comply, 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 AIFMs 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 with which AIFMs have to comply when investing on behalf of AIFs in specific types of asset: 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. AIFMs 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 business plan and therefore with the duration of the AIF. In particular, AIFMs 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. AIFMs should also maintain evidence of significant investment opportunities, if any, initially examined when selecting the possible transactions e.g. a list of the visited companies belonging to a specific

industrial sector or a list of real estate visited by the AIFM. AIFMs are not obliged to keep records of every investment opportunity examined or considered but only significant ones.

16. AIFMs should deliver to their senior management the proposal to invest in a certain target company or piece of 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.

Box 12**Reporting obligations in respect of execution of subscription and redemption orders**

1. Where AIFMs 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 and/or the acceptance of the subscription offer as the case may be.
2. Paragraph 1 shall not apply where another person is obliged to provide the investor with a confirmation concerning the execution of the order and where the confirmation contains the essential information. The AIFM has, however, to ensure that this other person complies with its obligations.
3. AIFMs shall supply the investor, upon request, with information about the status of the order and/or the acceptance of the subscription offer as the case may be.

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.
18. For limited partnerships, subscription is possible only by entering into a deed of adherence or other document subscribing to the limited partnership, but no units are issued to the investor and there is no order for subscription. Therefore, in such cases where the investor has been provided with a subscription agreement or a deed of adherence which states the amount of the subscription in the AIF, this shall satisfy the subscription requirement.
19. Where the subscription or redemption orders are processed by a third party (e.g. a third party distributor) and not by the AIFM, it should rather be the respective third party obligation to comply with the reporting obligations under paragraph 1 of Box 12.

Box 13**Selection and appointment of counterparties and prime brokers**

1. When selecting and appointing counterparties and prime brokers AIFMs should exercise due skill, care and diligence before entering into an agreement and on an ongoing basis by considering the full range and quality of their services. AIFMs 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 to the AIFM or the AIF.
2. For the purpose of paragraph 1 AIFMs should maintain a list of the appointed prime brokers approved by senior management. Only in exceptional cases and subject to approval by senior management may the AIFM appoint prime brokers not included in the list. The AIFM should be

able to 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 or an AIF in an OTC transaction, in a securities lending or in a repurchase agreement.

Explanatory text

20. 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 or an AIF in an OTC transaction, in a securities lending or in a repurchase agreement. The term 'OTC transaction' refers to over-the-counter trading (as opposed to trading on regulated markets) of financial instruments such as derivatives, bonds or securities.
21. The selection of counterparties and prime brokers should be based on certain criteria: these entities should be subject to on-going 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 to the AIFM or the AIF. However, this does not prevent AIFMs 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 AIFMs buy or sell financial instruments or other assets and for the purpose of paragraph 1, they 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. AIFMs 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, AIFMs 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. AIFMs 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. AIFMs should be able to demonstrate that there is no choice of different execution venues.

Explanatory text

22. Management companies managing UCITS must already comply with best execution rules according to Article 25 UCITS IV Level 2. Management companies and AIFMs 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 asset in which AIFs are invested should be taken into account.

23. 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 nevertheless 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 AIFMs 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 paragraph 2 of Box 14.

For those purposes, AIFMs 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. AIFMs 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, AIFMs 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. AIFMs 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, AIFMs should not be obliged to comply with paragraph 2 to 4. AIFMs should be able to demonstrate that there is no choice of different execution venues.

Explanatory text

24. 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.

25. 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.

26. 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 nevertheless 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. AIFMs 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 AIFMs 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.

AIFMs 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

27. 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 AIFMs 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 extensive 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).

28. In line with the UCITS approach ESMA does not advise adoption of 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. AIFMs 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

29. 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 AIFMs 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 17 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 case 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).

30. In line with the UCITS approach ESMA does not advise the adoption of Article 48(1)(b) MiFID Level 2, which requires the investment firm to disclose to each retail 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. AIFMs 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 of the AIFMD), 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. AIFMs 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

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

32.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. 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.

33.The inducement rules set out in Box 18 should be aligned with any future developments of the MiFID rules following the EU Commission proposal published on 20 October 2011.¹⁴

34.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

¹⁴ http://ec.europa.eu/internal_market/securities/isd/mifid_en.htm

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

35. ESMA was requested to provide advice on the criteria to be used by the relevant competent authorities to assess whether AIFMs comply with certain obligations under the Directive, including in this respect treating all AIF investors fairly.
36. ESMA acknowledges the need identified 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.
37. 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 subjectivity 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.
38. 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 are called into question on grounds of fairness. 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 it is established that fair treatment by an AIFM requires that no investor may obtain a preferential treatment that has an overall material disadvantage to other investors and the competent authority cannot demonstrate that there has been a material overall disadvantage to investors, it will not be able to act on fairness grounds).
39. 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, without comprehensively defining fairness.

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 was 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 was 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 consultation 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'.¹⁵
4. As for the steps an AIFM should be expected to take in order to identify, prevent, manage, monitor and disclose conflicts of interest, the advice also recommends consistency with the regulatory framework for UCITS Level 2 and MiFID Level 2.

Box 20

¹⁵ <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD341.pdf>

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

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. Examples of conflicts of interest are given below 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’):
 - For 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 of the investors.
 - The 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).

- The 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).
- The 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).
- The 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.
- The 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.
- The 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.
- The 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 on 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’):
- An AIFM that has invested in a portfolio company and receives from 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. AIFMs 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 framework (Article 18 UCITS Level 2) and 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 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 21 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), AIFMs 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. AIFMs 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) the investor has been notified of the address of the website, and the place on the website where the information may be accessed, and has consented to the provision of the information according to such modalities;
 - (b) the information must be up to date;

- (c) 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, AIFMs should keep and regularly update a record of the types of activity 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 AIFMD, AIFMs shall disclose non-systematic conflicts of interest to the AIF investors.
17. Furthermore, Article 14(2) of the AIFMD 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' interests will be prevented.
18. In addition, Box 23 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 AIFs.
19. With regard to the form of disclosure paragraph 2 requires that AIFMs 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. AIFMs 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 concerned and its investors.
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), AIFMs should develop strategies for the exercise of voting rights. However, since the AIFMD regulates marketing to professional investors unlike Article 21(3) UCITS Level 2, a summarised 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 ESMA 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 by taking into account relevant articles of the UCITS Directive while considering the heterogeneous population of AIFs and AIFM.
2. Respondents to the consultation stressed that it may be difficult for some managers to meet the requirements on functional and hierarchical separation, particularly small self-managed AIFs or private equity and venture capital managers. ESMA would like to stress that Box 30 and the related explanatory text of the present advice recognise these difficulties. According to ESMA, competent authorities in charge of reviewing the functional and hierarchical separation of the risk management function should apply the principle of proportionality taking into account, inter alia, the operational structure of the AIFM and the corporate governance arrangements at the AIFM/AIF.
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 manage 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 hierarchical 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 AIFMs 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 will necessarily involve periodic review.
5. To achieve a robust risk management framework, AIFMs 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 additionally 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 diligence AIFMs 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 AIFMs may perform. ESMA considers it is more appropriate to focus on and to enhance the governance structures envisioned under the UCITS 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.

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 on-going 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 set out how those elements of the risk management provisions in Articles 12, 23 and 38-43 of the UCITS Implementing Directive should be applied in the AIFMD context.

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 on-going basis all risks relevant to each AIF's investment strategy, to which each AIF is or may 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 been 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); 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 on-going 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 identify 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, whom it directs, but some or all members of senior management may comprise the governing body which may also contain non-executive members.

Box 26

Risk Management Policy

1. AIFMs shall establish, implement and maintain an adequate and documented risk management policy which identifies all the relevant risks to which the AIFs 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 appropriate, the supervisory function.
5. For the purposes of paragraphs 1-4, AIFMs shall take into account the nature, scale and complexity of their business and of the AIFs they manage.

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 types of AIFM. However, ESMA recommends that AIFMs take into account the nature, scale and complexity of their business and of the AIFs they manage 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.

Box 27

Assessment, monitoring and review of the risk management policy

1. AIFMs 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. AIFMs 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. AIFMs 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 to 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 independent 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.
17. The 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 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.

Box 28

Measurement and Management of Risk

1. AIFMs 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; and
 - (b) ensure compliance with the limits set in accordance with Box 29.
2. The 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, AIFMs 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 appropriate stress tests and scenario analyses 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 the UCITS Directive, thereby building on the standards which apply to UCITS management companies and ensuring consistency.
21. AIFMs 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. AIFMs 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 AIFMs 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 AIFs.

24. ESMA considers that AIFMs 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 methodology that AIFMs should employ. ESMA has, however, provided advice which seeks to achieve the outcome that all AIFMs 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.

Box 29

Risk Limits

1. AIFMs 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 AIFMs shall take into account the strategies and assets employed in respect of each AIF they manage as well as the national rules applicable to each of those AIFs. 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 risk 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)¹⁶ but did include reference to all those risks listed above, which are also applicable to AIFs.
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
 - failure in trading, settlement and valuation services.
27. AIFMs 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 AIFMs; therefore, where the AIFM does not set quantitative limits it should be able to justify this to the competent authority.
29. The AIFMD does not impose any investment restrictions on AIFs. 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 AIFMs 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:
- ‘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*

¹⁶ <http://www.esma.europa.eu/popup2.php?id=5620>

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).’

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 management 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 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 from the list below (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 risk management function is subject to an appropriate independent review to ensure that decisions are being arrived at independently;

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| <p>(d) that there is a review of the risk management function by an independent external party or, where applicable the internal audit function;</p> <p>(e) segregation of conflicting duties; and</p> <p>(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.</p> <p>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.</p> |
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Explanatory Text

31. ESMA was requested 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 otherwise 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 are set out in paragraph 3 of the Box while requiring review at an appropriate interval in line with paragraph 4.
34. A key safeguard is that the risk management function does not itself determine if it is functionally and hierarchically separated; rather, the AIFM's governing body make this determination, assesses the risks and sets the appropriate mitigating procedures.
35. The competent authority is charged with reviewing the functional and hierarchical 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.

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 AIF and, therefore, on their ability to meet redemption requests. As a result the AIFMD provides that AIFM must implement, for each AIF under their management, excluding unleveraged closed-ended AIFs, 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 undertakings (CIUs) 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. ESMA has had regard to the work being undertaken in international fora to assist in the development of its advice.
3. 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 AIFMs by Article 16(1) and (2) of the AIFMD.
4. Respondents to the consultation commented on the requirement for AIFMs investing in other CIUs to monitor the approach to liquidity management adopted by the manager of those CIUs. In their view, this requirement may impede some AIFs from investing in certain highly-liquid underlying investments where it would be impractical for them to undertake such monitoring. ESMA was not convinced by this argument and strongly believes that AIFMs should carry out specific due diligence in relation to the liquidity of the underlying AIF which includes monitoring of the liquidity profile of the collective investment undertakings.
5. Some stakeholders felt that ESMA's advice was not tailored enough to take into account the variety of AIFs. The heterogeneous and diverse nature of the population of AIFs within the scope of the Directive presents significant challenges to specify the detailed mechanics or procedures for the management of liquidity. ESMA has therefore set out fundamental general requirements to all AIFMs which can be adapted to the diverse size and structure of the AIFM and to the nature of the AIF under management. 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.

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.*

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 type of units or shares of the AIF and which is a bespoke or separate arrangement from the general redemption rights of investors.

Explanatory Text

- 6. 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 considers that, as the Directive imposes an obligation on AIFMs 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.
- 7. ESMA is of the opinion that a special arrangement is one type of tool or arrangement for managing liquidity. ESMA defines special arrangements with reference to the relevant provision in the Directive which states that 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’ should be considered as special arrangements where they achieve similar outcomes to those achieved by side pockets.

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) of this Box 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 their 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 into 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, before they invest in the AIF and in the event of material changes;

- (f) AIFMs shall consider and put into effect the tools and arrangements necessary to manage the liquidity risk of each AIF under management. AIFMs shall identify the types of circumstances where tools and arrangements may 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

8. 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 has therefore set out 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.
9. 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.
10. 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.
11. 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 paragraphs 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 33 are also not applied to AIFM managing AIFs of the closed-ended type.
12. The principle of proportionality should be applied in application of the requirements to the nature (e.g. taking into consideration the types of underlying 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 as-

sets). However, AIFMs must be able to demonstrate to their competent authorities that appropriate and effective liquidity management policies and procedures are in place.

13. 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. While ESMA does not wish to detract in any way from this overarching obligation on AIFMs, 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.
14. 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.
15. 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. AIFMs should consider the liquidity of the types of instrument 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.
16. 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 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 pockets, lock ups or penalties.
17. 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 authori-

sation. Consistent with the proposals in the recent consultation issued by IOSCO on ‘Principles on Suspension of Redemptions in Collective Investment Schemes’¹⁷, 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.

18. 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.
19. ESMA agrees with the view expressed by IOSCO in its recent consultation and in the report produced by IOSCO on suspending redemptions, that ‘generally, suspensions may be justified only in exceptional circumstances’. 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 episodes of illiquidity or valuation problems for a specific amount of assets in the AIF.
20. ESMA believes that in any event, the policies and procedures of AIFMs 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 AIFs because such AIFs do not generally allow redemptions on the same terms as open-ended AIF.
21. 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.
22. 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.
23. 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.

¹⁷ <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD349.pdf>

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 into 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

24. 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 provide 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.
25. 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.

26. 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 into 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. AIFMs 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. AIFMs should account for valuation sensitivities under stressed conditions in their 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. Therefore, it is important that these factors are considered as part of this process.
27. 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.

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

28. The Commission requested 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.
29. 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 into account in assessing whether investors' ability to redeem is consistent with the fair treatment of investors as a body.
30. 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.

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 was 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 CEBS¹⁸ and CEIOPS¹⁹ 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 of Solvency II and the AIFMD. Given that CEIOPS' advice was based on the full set of the relevant provisions of the CRD, the approach for AIFMs and UCITS should be based on CEIOPS' advice (and therefore at the same time be based on

¹⁸CEBS 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>

¹⁹CEIOPS 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

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 AIFs (or UCITS respectively) in securitisation positions. This should provide for the desirable and proportionate level of cross-sectoral consistency requested by the Commission.

4. CEBS has issued further Guidelines²⁰ which deal with specific issues at a micro level that would not be appropriate to be fully taken into account for the purposes of ESMA's advice. 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 different types of securitisation or specific roles of parties to a securitisation transaction.
5. Some respondents to the consultation paper asked for more harmonisation with the rules set out under the CRD and Solvency II frameworks. In the light of the feedback received, ESMA made some further alignments with the relevant provisions of the CRD in order to ensure the required level of cross-sectoral consistency.
6. Further, it has been argued in response to the consultation 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. AIFMs should only assume exposure to the credit risk of a securitisation position on behalf of one or more AIFs if the originator, sponsor or original lender has explicitly disclosed to the AIFM 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 should be

²⁰ Guidelines to Article 122a of the Capital Requirements Directive, 31 December 2010, <http://www.eba.europa.eu/Publications/Standards-Guidelines.aspx>.

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 and this is not due to the natural payment mechanism of the transaction, 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. Please note that the retention requirement according to Box 35 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. The term 'to assume exposure to' has been used throughout this section of the advice 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. To this extent, 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'). The relevant provisions of the CRD, especially Art 122a(1) CRD ('shall be exposed to') apply the same principle.
11. The following excerpts from the CEBS Guidelines to Article 122a of the Capital Requirements Directive are also relevant:
 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 2010²¹ 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

²¹

<http://www.esma.europa.eu/cebs/media/Publications/Standards%20and%20Guidelines/2010/Application%20of%20Art.%20122a%20of%20the%20CRD/Guidelines.pdf>

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.’

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 and this is not due to the natural payment mechanism of the transaction, 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 (i.e. assuming exposure) in a further transaction in which such party in breach is involved. 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 AIFs.
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 on exposure to the credit risk of securitisation positions in the CRD that, in the interests of cross-sectoral consistency, ESMA considers should also apply to AIFMs that invest in the credit risk of a securitisation position on behalf of one or more AIF (please refer to Box 35, Paragraph 5).

Requirements for sponsors and originator credit institutions

- Prior to an AIFM assuming exposure to the credit risk of a securitisation position on behalf of one or more AIFs, 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 based on Article 122a(6), sub paragraph 1 CRD and Annex V(3) CRD²² (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

²² Directive 2006/48/EC in this case.

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 its 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 itself 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 would show that the requirements according to Box 36, paragraph 1 are satisfied. Further, the respective party of the securitisation transaction should commit to give immediate notice in case the fulfilment of the requirements according to Box 36, paragraph 1 is in doubt or are breached (e.g. according to an internal audit report).

24. To satisfy the requirements of Box 36 paragraph 1, the AIFM may rely on the information given in the offering circular or the prospectus, if existing, and, only in such case, is not obliged to approach the sponsor, originator credit institution or original lender (as applicable).

Box 37

Requirements for transparency and disclosure of retention

1. Prior to an AIFM assuming exposure to the credit risk of a securitisation position 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

25. The requirement is based on the following 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.

26. The purpose of this requirement 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

27. CEBS has issued Guidelines on the specific ways 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

28. 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 transac-

tion 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. 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 AIFMs**

Box 38

Requirements for risk and liquidity management

1. AIFMs assuming exposure to the credit risk of a securitisation position on behalf of one or more AIFs 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. AIFMs that assume exposure to these products on behalf of one or more AIFs 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.

29. 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).

30. In order to point out the particular importance of 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 38 paragraph 1 (based on 3.54 CEIOPS' Advice) to the wording of Article 15(3)(c) AIFMD.

31. 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.*

32. 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 the credit risk of a securitisation position 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, AIFMs 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.

33. 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 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.

34. Further, taking into account the parallel provision of Article 122a(5) sub paragraph 2 CRD, in order to fulfil the requirements for monitoring procedures, 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 waterfall related triggers, credit enhancements, liquidity enhancements, market value triggers, and deal-specific definition of default.

35. 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 39 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 AIFs) a material value of the credit risk of a securitisation position, 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).

36. 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.

37. Article 122a(4) sub paragraph 2 CRD provides for a stress testing requirement for credit institutions. Box 40 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 the credit risk of a securitisation position on behalf of one or more AIFs, 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. AIFMs 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. AIFMs 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.

38. 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.

39. 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 AIFMs that have assumed exposure to the credit risk of a securitisation position on behalf of one or more AIFs that was 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.

40. Box 42 aligns the advice with Article 122a(8) CRD and, Paragraph 3.60. of CEIOPS' advice. 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 the credit risk of a securitisation position according to the limits of the UCITS Directive.
2. For the purpose of the read-across of the requirements set out above applicable to AIFMs 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 read-across of the requirements set out above applicable to AIFMs 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.

41. 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 sectors with respect to the exposure to a securitisation position that could reasonably justify such deviation.

42. The provisions in Box 43 were drafted with a view to incorporating the principles applicable to AIFMs 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. ESMA considered the first option more appropriate.

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 was 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. While taking the view that both UCITS and MiFID rules should serve as a starting point, most of the respondents to the consultation 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 the advice seeks to achieve an appropriate level of consistency with the UCITS and MiFID regime while taking into account the particularities of AIFs and the diverse assets in which they may be invested. Many AIFMs are already authorised 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 AIFMs that also operate as management companies or investment firms have to comply with different or overlapping regulatory standards in relation to their business.

General requirements on procedures and organisation

1. AIFMs should comply with the following requirements:
 - (a) 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) ensure that their relevant persons are aware of the procedures which must be followed for the proper discharge of their responsibilities;
 - (c) establish, implement and maintain adequate internal control mechanisms designed to secure compliance with decisions and procedures at all levels of the AIFM;
 - (d) 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) maintain adequate and orderly records of their business and internal organisation.

AIFMs 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. AIFMs 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. AIFMs 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. AIFMs 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. AIFMs 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 take appropriate measures to address any deficiencies.

Explanatory text

4. Box 44 covers general principles of procedures and organisation with which AIFMs have to comply 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.

5. When establishing and implementing the necessary procedures and organisational structure, AIFMs should take into account the principle of proportionality i.e. the procedures, mechanisms and organisational 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. AIFMs should employ sufficient personnel with the skills, knowledge and expertise necessary for the discharge of the responsibilities allocated to them.
2. AIFMs should ensure that the performance of multiple functions by relevant persons does not and is not likely to prevent those relevant persons from discharging any particular function soundly, honestly and professionally.
3. For the purposes laid down in paragraphs 1 and 2, AIFMs 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

6. Box 45 requires AIFMs 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. AIFMs should make appropriate and sufficient 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. AIFMs 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

7. In line with the UCITS approach (Article 7 UCITS Level 2) AIFMs 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. AIFMs should employ accounting policies and procedures as referred to in Box 44 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 times. If an AIF has different investment compartments, separate accounts shall be maintained for those investment compartments.
2. AIFMs 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

8. In line with the UCITS approach (Article 8 UCITS Level 2) AIFMs 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 AIFMD.
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) 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 AIFMD.
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 AIFMD;
 - (b) take appropriate measures to address any deficiencies.
4. AIFMs 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. AIFMs 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. AIFMs 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

9. 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).
10. 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.

Box 49

Permanent compliance function

1. AIFMs 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 AIFMD, 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 the Directive.

AIFMs 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. AIFMs 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 AIFMD.
3. In order to enable the compliance function referred to in paragraph 2 to discharge its responsibilities properly and independently, AIFMs 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

11. ESMA recommends that AIFMs 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).
12. 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 organisation 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.
13. 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 AIFMs 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.

14. 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. If the AIFM makes use of the exemption, it should document the reasons.
15. 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. AIFMs 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

16. In line with the UCITS (Article 11 UCITS Level 2) and the MiFID (Article 8 Level 2) approach, AIFMs should establish and maintain an internal audit function separate and independent from other functions and activities of the AIFM. Where this separation and independence would 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.

Personal transactions

1. AIFMs 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 AIFs or transactions with or for AIFs 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

17. Box 51 is based on Article 13 UCITS Level 2 and requires AIFMs 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 AIFs.

18. Unlike Article 13 UCITS Level 2, Box 51 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.

19. However, ESMA acknowledges that there may be assets in relation to which a misuse of confidential information is rather unlikely e.g. deposits.

Recording of portfolio transactions

1. AIFMs should make without delay for each portfolio transaction relating to AIFs a record of information which is sufficient to reconstruct the details of the order and the executed transaction or of the agreement.
2. With regard to portfolio transactions on an execution venue, 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;
 - (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;
 - (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) for executed transactions the counterparty and execution venue identification.
3. With regard to portfolio transactions by the AIF outside an execution venue, the record referred to in paragraph 1 shall include:
 - (a) the name or other designation of the AIF;
 - (b) the legal and other documentation that forms the basis of the portfolio transaction, including in particular the agreement as executed;
 - (c) the price.
4. For the purpose of paragraphs 2 and 3, 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

20. 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.
21. 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' and makes a distinction between portfolio transactions which take place on an execution venue and portfolio transactions which take place outside an execution venue.

Box 53**Recording of subscription and redemption orders**

1. AIFMs 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 or submitting the subscription request;
 - (c) the person receiving the order or the subscription request;
 - (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 or the date of accepting the subscription request;
 - (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

22. In line with the UCITS approach (Article 15 UCITS Level 2), Box 53 requires AIFMs to ensure that AIF subscription and, where relevant, redemption orders are recorded. The provisions are based on the relevant UCITS provisions 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 AIFs 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. AIFMs should ensure that all required records referred to in Box 52 (portfolio transactions) and Box 53 (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 AIFMs 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 AIFMD.

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

23. In line with the UCITS (Article 16 UCITS Level 2) and MiFID (Article 51 MiFID Level 2) approach, Box 54 requires AIFMs 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 of whether they are open-ended or closed-ended AIFs. 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

24. Since the AIFMD regulates 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).

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 was requested to advise the Commission on criteria for the proper valuation of assets and the calculation of the net asset value. Furthermore, ESMA was requested to advise on the type of specific professional guarantees an external valuer should be required to provide. Thirdly, ESMA was requested to advise on the frequency of valuation carried out by open-ended funds.
2. The respondents to the consultation emphasised 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.
3. With regard to the policies and procedures for the valuation of the assets of the AIF, respondents highlighted that it should be required to the AIFM neither to adopt a single approach to the valuation of a specific legal type of asset in all circumstances nor to apply the same policies and procedures across all AIF having the same AIFM.
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. ESMA requires that an AIFM shall not invest in a particular type of asset for the first time unless appropriate valuation methodologies have been identified, but acknowledges that a single approach to the valuation of a specific legal type of asset in all circumstances shall not be required. ESMA further recognises that the consistent application of the valuation methodologies shall take into account factors like the fact that AIFM often manage AIF located in different jurisdictions which are subject to the local valuation rules and requirements.
6. 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.
7. 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 with respect to the assets he is appointed to value.
8. 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. AIFMs should ensure that, for each AIF they manage, 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, AIFMs should ensure that fair, appropriate and transparent valuation methodologies are applied for the AIFs they manage in accordance with the 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 asset in which the AIF may invest according to applicable national law, the AIF rules and the instruments of incorporation. An AIFM shall not invest in a particular type of asset for the first time unless appropriate valuation methodologies have been identified.
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 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 AIFMD. 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

9. 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 the obligation of proper valuation, the AIFM has to establish and maintain sound, transparent and appropriately documented valuation procedures. This rule applies to all AIFMs. 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.
10. Since AIFMs regularly employ 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 asset 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.
11. 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, particularly with regard to Article 19 (5) of the AIFMD.
12. Due to the diversity of assets in which an AIF may invest, it may be difficult for an AIFM/AIF to find a valuer capable of properly valuing all portfolio assets. Hence, an AIFM may have several external valuers for any one AIF in order to ensure a proper valuation of all assets. The external valuer may be appointed by either the AIFM (e.g. where the AIF is constituted under the law of contract and has no own legal personality) or by the AIF where the AIF is internally managed.
13. The description of the obligations, role and responsibilities includes all parties performing the valuation function. This will also include the external valuer.
14. Paragraphs 4 and 5 set out specific requirements for the policies depending on whether 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 the 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 organisational requirements to ensure the functional independence of the process for valuation of assets. An inde-

pendent 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. AIFMs 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

15.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 an internal or an external 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. Unless circumstances arise suggesting an update is required, the policies and procedures shall be applied consistently over time and valuation sources and rules shall remain consistent over time.

Explanatory Text

16. 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 asset 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 periodic review of the policies and procedures, including the valuation methodologies. 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

17. 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. A review of the policies and procedures including the valuation methodologies should be carried out at least annually. In addition, the policies and procedures should be reviewed prior to the AIF's 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 strategy and investment. 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 by type of asset the way the appropriateness and fairness of the individual values is assessed. 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

18. 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.
19. Paragraph 2 sets out additional requirements with which an AIFM has to comply when investing on behalf of the AIF in specific types of asset. For some assets, especially complex and illiquid financial instruments, there is a higher risk of inappropriate valuation. It is recognised 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 even impossible 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 used 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.
20. The AIFM should put in place 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 realised 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 or redemption or cancellation 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 remedial 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

21. 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 covers only the procedure for the calculation but not 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 remedial 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.
22. The duty to calculate the net asset value per unit or share is linked to issues, subscriptions, redemptions or cancellations taking place. This link is made in order to ensure investors and AIFs receive the correct equivalent for their money respectively the units or shares.
23. 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 of the Directive. 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.
24. 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.
25. 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, including those requiring subjective judgement, 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 understandingin respect of 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

26. The professional guarantees as described in the advice are designed to provide evidence of the external valuer's qualification and capability to perform the valuation. In order to perform this function, the external valuer has to have 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 valuer's 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 real estate assets, he is required to supply resources, procedures, knowledge and understanding which are sufficient in respect to those assets. In case he is to value the complete AIF he has to furnish professional guarantees to demonstrate his qualification and capability in respect of 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

27. The calculation of the net asset value per unit or share has to be carried out on the occasion of each issue or subscription or redemption or cancellation 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 advice takes into account that there are differences in the valuation procedures with respect to the types of asset held by the AIF. There are valuation procedures that can be performed on a daily basis such as the valuation of financial instruments, but there are also procedures that cannot be done with the same frequency as issues, subscriptions, redemptions and cancellations 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 was 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. Detailed feedback on the comments made by stakeholders to the proposal made in the consultation in relation to the implementing measures on Article 20 of the AIFMD is provided in Annex IV of the advice. Feedback in this section is set out only in a summarised form and covers only some of the issues raised in relation to delegation.
3. With regard to the criteria to be used for the assessment of the delegation's rationale, while the majority of the respondents to the consultation preferred the option 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, an important number of respondents either opted for the second option setting out an indicative, non-exhaustive list of criteria to be used when making the assessment or suggested a combination of both options.
4. Given the feedback received, ESMA decided to opt for the combination of the two options which represents a solution taking into due account the mixed views expressed by the respondents and should be satisfactory for the achievement of the relevant regulatory purposes. Thus, the advice establishes the general principle according to which the AIFM shall 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 and also sets out a non-exhaustive list of criteria to be used for assessing whether or not objective reasons for delegating tasks subsist.
5. Many respondents challenged the concept of equivalence of the local criteria on the basis of which the delegate is authorised or registered for the purpose of asset management which was set out in the consultation in order to assess whether the third country undertaking to which portfolio management or risk management is delegated satisfies the requirement under Article 20(1)(c) of the AIFMD.
6. ESMA agreed to remove the reference to the notion of equivalence from the provisions of its advice, in order to recognise the distinction at Level 1 between the requirements on third country depositaries, which explicitly envisage an assessment of the relevant regulatory framework, and those on delegation, which do not make provision for such an assessment.
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 authorised 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.



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 AIFMs in performance of a function. The AIFM must perform at least investment management functions referred to in Annex I (1)(a) or (b) 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 31 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, including property management services;
- (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 the AIF and 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 authorised 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 maintained 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 dele-

gate 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 authorised 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.

Objective Reasons

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.

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. 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. The rule 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 authorised 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.

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. In performing the evaluation, the AIFM should consider at least the following factors:

(a) in determining whether the delegate has sufficient resources, whether 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.

(b) in determining whether the persons who effectively conduct the business which the delegate will perform for the AIFM have sufficient experience, whether they have appropriate theoretical knowledge and appropriate practical experience in the relevant functions.

(c) in determining whether the persons who effectively conduct the business of the delegate are of sufficiently good repute, whether there are any 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.

Where the delegate is regulated in respect of its professional services within the European Union, the AIFM may presume that the factors in (c) are satisfied.

Explanatory text

23. 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.

24. 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 and if it retains the necessary organizational structure for performing the delegated tasks effectively.

25. For the purposes of assessing whether 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.

26. For the purposes of assessing whether the persons who effectively conduct the business of the delegate are of sufficiently good repute, the AIFM should consider whether they have any 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.

27. When evaluating any 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.

28. If the delegate is established in the EU and authorised 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

The following entities should be considered as authorised for the purpose of asset management and subject to supervision:

- management companies authorised under the UCITS Directive;
- investment firms authorised under MiFID to perform portfolio management;
- credit institutions authorised under Directive 2006/48/EC having the authorisation to perform portfolio management under MiFID; and
- externally-appointed AIFMs authorised under the AIFMD.

Explanatory text

29. Article 20(1)(c) of the AIFMD 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.

30. ESMA is invited to advise the Commission on the types of institution that should be considered to be authorised 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 institution in this context.

31. Box 67 specifies categories of eligible institutions that should be considered to be authorised or registered for the purpose of asset management and subject to supervision. These are management companies authorised under the UCITS Directive, investment firms authorised under MiFID to perform portfolio management, credit institutions authorised under Directive 2006/48/EC having the authorization to perform portfolio management under MiFID, and externally-appointed AIFMs authorised under the AIFMD.
32. Investment companies authorised under the UCITS Directive are not listed in Box 67 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.
33. For the same reasons, internally-managed AIFs are not listed in Box 67. 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.

Box 68

Delegation of portfolio management or risk management conferred on a third-country undertaking

1. Where the delegation concerns portfolio management or risk management, in order to fulfil the requirement set out in Article 20(1)(d) of the AIFMD, a written arrangement should exist 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.
2. Where the undertaking sub-delegates any of the portfolio management or risk management functions delegated to it, a written arrangement should exist between the competent authorities of the home Member State of the AIFM or ESMA and the relevant supervisory authorities of the undertaking to which sub-delegation is conferred.
3. Where the sub-delegate further delegates any of the portfolio management or risk management functions delegated to it the conditions in paragraph 2 shall apply mutatis mutandis.
4. With respect to the delegated functions from the entity to which functions were delegated or sub-delegated, the arrangement referred to in paragraphs 1 and 2 above should allow the competent authorities to:
 - a) obtain on request the relevant information necessary to carry out their supervisory tasks as provided for in AIFMD;
 - b) obtain access to the documents relevant for the performance of their supervisory duties maintained in the third country;
 - c) carry out an on-site inspection on the entity to which functions were delegated or sub-delegated. The practical procedures for on-site inspections should also be detailed in the arrangement;

- d) receive as soon as possible information from the supervisory authority in the third country in the case of breach of the requirements of the AIFMD and its implementing measures;
 - e) ensure that sufficiently dissuasive enforcement actions can be performed by the third country and the EU competent authorities in cases of breach of the requirements of the AIFMD and its implementing measures.
5. Where the delegation concerns portfolio management or risk management, the third country undertaking should be deemed to satisfy the requirement under Article 20(1)(c) when it is authorised or registered for the purpose of asset management based on local criteria and is effectively supervised by an independent competent authority.

Explanatory text

34. Article 20 sets the conditions for delegation, sub-delegation and further sub-delegation of core functions such as portfolio management or risk management. In cases of delegation of portfolio management and risk management to entities established in third countries, the existence of appropriate co-operation with the third country supervisory authority is of paramount importance.

35. Article 20(1)(d) provides that ‘where the delegation concerns portfolio management or risk management and is conferred on a third-country undertaking, in addition to the requirements in point (c), co-operation between the competent authorities of the home Member State of the AIFM and the supervisory authority of the undertaking must be ensured’.

36. In relation to sub-delegation Article 20(4) provides that ‘the third party may sub-delegate any of the functions delegated to it provided that the following conditions are met: (...) (c) the conditions set out in paragraph 1, on the understanding that all references to the ‘delegate’ are read as references to the ‘sub-delegate’. Paragraph 6 of the same Article clarifies that ‘where the sub-delegate further delegates any of the functions delegated to it, the conditions set out in paragraph 4 shall apply mutatis mutandis’.

37. The joint reading of the above-mentioned provisions implies that the requirements dealing with co-operation arrangements with third countries apply not only with respect to the delegation of portfolio management and risk management by the AIFM but also in cases where the third party sub-delegates these functions.

38. Given the relevance of the delegated core functions both in terms of investor protection and containment of systemic risk, it is envisaged that the co-operation should be based on written arrangements. The ability of the competent authority of the home Member State of the AIFM to obtain information on request or to have access to information and to the delegated entities should be well-grounded and based on arrangements in place before the delegation starts.

39. The detailed content of these arrangements should be based on existing international standards and, in particular, the IOSCO MMoU concerning consultation and co-operation and the exchange of information of May 2002 with respect to co-operation for enforcement purposes and, for supervisory purposes, the IOSCO Technical Committee Principles for Supervisory Co-operation (including the

sample MoU concerning consultation, co-operation and the exchange of information related to the supervision of cross-border regulated entities).

40. These arrangements could take the form of an MMoU centrally negotiated by ESMA which would obviate the need that third country regulators conclude different bilateral co-operation arrangements and would ensure a level playing field.
41. A third country authority should be deemed to be independent if it is fully compliant with the criteria set out in Part II ("The Regulator") of the IOSCO Objectives and Principles for Securities Regulation and relevant Methodology, and the Basel Committee Core Principles and the relevant Methodology²³. These criteria will be used by ESMA and the EU competent authorities as a reference and a third country authority may meet other equivalent criteria. The third country competent authorities should have the powers to obtain information, also on behalf of a foreign authority, and to enforce the relevant requirements under their domestic legislation.
42. The provision in paragraph 4)c) of Box 68 according to which the competent authorities should be allowed to carry out an on-site inspection on the entity should be understood as covering two situations: i) where the competent authority of the home Member State of the AIFM requests the supervisory authority of the undertaking to which functions are delegated to carry out an inspection on its behalf; and ii) where the competent authority of the home Member State of the AIFM requests permission from the supervisory authority of the undertaking to which functions are delegated to carry out an inspection itself, or to accompany the personnel of the third country supervisory authority in order to assist them in carrying out the inspection.
43. The advice in paragraph 5 of Box 68 relates to the requirement in the first four lines of Article 20(1)(c) i.e. that delegation of portfolio management or risk management can only be to an undertaking authorised or registered for the purpose of asset management. As set out in the remainder of that article, where this condition cannot be met there must be prior approval by the competent authorities of the home Member State of the AIFM.

Box 69

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.

²³ <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf>

(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:

44.Box 69, 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)).

45.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 70

Sub-delegation – General principles

The conditions set out in Boxes 63-67 and 69 should apply mutatis mutandis where the delegate sub-delegates any of its functions to a sub-delegate.

Box 71

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

46.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.

47.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.

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 and 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, on the understanding that the delegate/ sub-delegate shall, in any event, put in place specific safeguards against conflicts of interest allow for the independent performance of risk management activities.

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

48. 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.
49. ESMA was 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.
50. 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.
51. 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.
52. 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, provided that specific safeguards against conflicts of interest are put in place.

Box 73

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 authorised 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 74

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

53. 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.

54. 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.

55. 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 advice in this area covers the following elements:
 - i. Appointment of the depositary
 - ii. General criteria for assessing the effective prudential regulation and supervision of third countries
 - iii. The depositary's duties
 - iv. The depositary's liability regime

Appointment of a depositary

2. In line with the request from the Commission, the 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 was not 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.

General criteria for assessing the effective prudential regulation and supervision of third countries

4. Article 21(6) of the Directive sets out the conditions under which a depositary established in a third country can be appointed, one of which is that the depositary is subject to 'effective prudential regulation, including minimum capital requirements, and supervision which have the same effect as Union law and are effectively enforced.' ESMA was requested to develop criteria for assessing whether the relevant third country framework are to the same effect as the provisions laid down in European law. ESMA's advice covers such elements as the capital requirements that should be in place, the rules on operating conditions and the existence of sufficiently dissuasive enforcement actions in case of breaches.

Duties of the depositary

5. 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

6. 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 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.

Oversight function

7. 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 advice aims to clarify each task.

Cash monitoring

8. The 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.
9. Regarding the tasks which would be expected of a depositary when implementing its cash monitoring obligations, the advice 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.
10. 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's advice clarifies 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

11. 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 was 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

12. 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 the assets of other depositaries and their clients, for whom it may be acting as delegate, in such a way that they can at all times be clearly identified as belonging to clients of a particular depositary. The Commission asked ESMA to clarify what the specific requirements should be to make sure the sub-custodian effectively meets that obliga-

tion. The 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’.

Depository liability

13. The depository’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 advice provides clear definitions of what would constitute: (i) the loss of a financial instrument; (ii) an external event beyond the reasonable control of a depository, the consequences of which would have been unavoidable despite reasonable efforts; and (iii) the objective reason which could enable a depository 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; the appointment 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 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 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 then suggested some amendments or new provisions to take into account the specificities of AIFs. 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-custodian²⁴, on the possibility to re-use the assets with which it has been entrusted, or a description of the types of asset it will have to safekeep (given that, unlike for UCITS, there is no harmonisation as to the types of asset in which an AIF can invest and the AIFMD covers an extremely wide spectrum of funds).
3. Precisely because the Directive regulates AIFMs which manage very different types of fund, ESMA decided not to elaborate a model agreement and provides a detailed explanation of why it did not consider that an appropriate means to improve harmonisation or investor protection.
4. There was broad support from respondents to the consultation for the approach of taking the UCITS requirements as a benchmark with adaptation to the AIFM sector where relevant, as well as for the decision not to develop a model agreement.

1 Contract evidencing the appointment of a depositary

Extract from the Commission's request

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.

ESMA is encouraged to provide the Commission, if possible, with a draft model agreement.

²⁴ 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 75

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 asset that will fall within the scope of the depositary's safekeeping and oversight 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;
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. Information on the tasks and responsibilities of the parties to the agreement in respect of obligations relating to the prevention of money laundering and the financing of terrorism, where applicable;
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 at the 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.

The details of the means and procedures set out in paragraphs 1 to 14 should be described in this agreement or in the service level agreement or similar document.

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 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).²⁵
6. ESMA considers that the tasks the depositary will need to perform to fulfil its safekeeping and oversight functions will depend on the types of asset with which it is entrusted rather than on the type of fund (UCITS or non UCITS). Therefore, the existing requirements regarding the particulars to be included in

²⁵ <http://www.esma.europa.eu/popup2.php?id=6150> (please refer to Section III)

the contract signed between the depositary of a UCITS and its management company served as a starting point and ESMA 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.

7. The following items were 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. The description should provide sufficient detail on the categories of asset without necessarily listing in an exhaustive manner each and every sub-category of instrument to be safekept. The description should also cover the geographical zones in which the AIF plans to invest in order to allow the depositary to fulfil the requirement to assess and monitor custody risks.
- 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 Boxes 77 and 78 below and the corresponding explanatory text).
- 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).

8. The following items were 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 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: whereas 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 advice 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 is 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).

9. The requirement in paragraph 11 of the Box regarding details of, and steps taken to monitor third parties, should be applied in relation to the entire custody chain.

10. Paragraph 13 requires that the depositary be informed at the opening of any new cash account opened in the name of the AIF or in the name of the AIFM on behalf of the AIF. Regarding the depositary's duties with regard to cash more generally, please refer to paragraph 28 of the Explanatory text under Box 81.

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 and is without prejudice to the powers of competent authorities to supervise the compliance of the AIFM with relevant regulatory requirements.

1.2 ESMA's justification for not providing a model agreement

12. There was a consensus among the respondents to the consultation 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 consultation, ESMA sees no need to define a model agreement. The provisions contained in the advice combined with the requirements detailed in the Level 1 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 legal structures of AIFs, 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, both of which 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. General criteria for assessing the effective prudential regulation and supervision of third countries

Extract from the Commission's request

CESR is requested to advise the Commission on the criteria for assessing whether the prudential regulation and supervision applicable to a depositary established in a third country with respect to its depositary duties are to the same effect as the provisions laid down in European law. In this regard, CESR is invited to take into account at least whether the depositary:

- a) is subject to specific capital requirements for the safe-keeping of assets.*
- b) is subject to supervision on an on-going basis.*
- c) provides sufficient financial and professional guarantees to be able to effectively pursue its business as a depositary and meet the commitments inherent to that function.*
- d) is subject to rules as stringent as those laid down in Article 21 AIFMD.*

CESR is requested to advise the Commission specifying the criteria for assessing that prudential regulation and supervision of a third country applicable to the AIF depositary with respect to its depositary duties established in a third country is to be considered as effectively enforced. Inter alia, CESR should take into account whether the depositary is subject to the oversight of a public authority, meaning that, at least:

- a) the authority has the power to request information from the depositary.*
- b) the authority has the power to intervene with respect to, and sanction, the depositary.*

Box 76

Criteria for assessment of prudential regulation and supervision applicable to a depositary established in a third country

1. For the purposes of the assessment provided for in Article 21 (6), the following criteria should be met:
 - a. The entity should be subject to authorisation and on-going supervision by an independent competent authority with adequate resources to fulfil its tasks;
 - b. The local regulatory framework should set out criteria for the eligibility to act as depositary that have the same effect as those set out for the access to the business of credit institution or investment firm within the EU;
 - c. The capital requirements imposed in the third country should have the same effect as those applicable in the EU as set out in Article 21 (6) (b) depending on whether the entity is of the same nature as a credit institution or an investment firm;
 - d. The operating conditions have the same effect as those set out for credit institutions or investment firms within the EU depending on the nature of the entity;
 - e. The requirements on the performance of the specific duties as AIF depositary established

in the third country regulatory framework have the same effect as those provided for in Article 21 (7) to (15) and in the relevant implementing provisions;

- f. The local regulatory framework provides for the application of sufficiently dissuasive enforcement actions in cases of breaches by the depositary of the requirements of the AIFMD and its implementing provisions;
- g. The liability of the depositary to the investors of the AIF can be invoked directly or indirectly through the AIFM, depending on the legal nature of the relationship between the depositary, the AIFM and the investors.

Explanatory text

1. The depositary established in a third country should be subject to regulation of a public nature and to prudential supervision performed by an independent competent authority.
2. Article 21(6) of the Directive sets out the preconditions concerning the possibility to appoint as a depositary an entity established in a third country requiring, inter alia, appropriate co-operation arrangements to be signed between competent authorities (including those of the countries where the units are to be marketed). Moreover, subparagraph b) expressly requires that the relevant entity is subject 'to effective prudential regulation, including minimum capital requirements, and supervision which have the same effect as Union law and are effectively enforced'.
3. This objective can only be achieved if the local regulation established in the third country guarantees that regulations of a public nature exist, the local competent authority performs on-going supervision and can perform investigations and impose sanctions.
4. A third country authority should be deemed to be independent if it is fully compliant with the criteria set out in Part II ('The Regulator') of the IOSCO Objectives and Principles for Securities Regulation and relevant Methodology, and the Basel Committee Core Principles and the relevant methodology.²⁶ The criteria will be used by ESMA and the EU competent authorities as a reference. This does not imply that the assessed authority needs to be a member of IOSCO or of the Basel Committee. The third country competent authority should have the powers to obtain information, also on behalf of a foreign competent authority, and to enforce the relevant requirements under its domestic legislation.
5. Where the supervision of the depositary in the third country involves multiple authorities, each of them should be fully compliant with the above-mentioned criteria. A primary competent authority should be appointed to act as the contact point for the purposes of the AIFMD.
6. As far as the assessment of the legislation is concerned, this should be made by comparing the eligibility criteria and the on-going operating conditions applicable to the depositary in the third country against the corresponding requirements provided for within the EU for credit institutions and/or investment firms for access to the depositary business and the performance of the deposi-

²⁶ <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf>

tary functions, with a view to ascertaining whether the local criteria have the same effect as those established under EU legislation. An entity which is subject to prudential oversight and licensed under a local category other than a credit institution or an investment firm may be assessed with a view to ascertaining whether the relevant local criteria have the same effect as those established under EU legislation for credit institutions and/or investment firms.

7. As provided for under Article 21(6), last sub-paragraph, of the AIFMD, the European Commission, having verified that the above-mentioned criteria are met, should 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.

V.III. 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. The advice specifies the tasks which would be expected of a depositary when implementing its cash monitoring obligations. In particular, the depositary is required 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 is in particular 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 the advice clarifies 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 for ensuring 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 cash accounts have been opened for the purpose of the AIF's operations.

Safekeeping

6. The depositary is responsible for safekeeping the AIF's assets. Depending on the type of asset, 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 by means of record keeping. ESMA was asked to provide advice on the types of financial instrument 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's advice sets out a clear definition of the financial instruments to be held in custody and adopts 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.

8. As a first step of the definition, ESMA's advice defines financial instruments as transferable securities (including those which embed derivatives in accordance with Article 51(3), final sub-paragraph of Directive 2009/65/EC and Article 10 of Directive 2007/16/EC), 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 the depositary should hold in custody those financial instruments it is in a position to instruct the transfer of; as such, all financial instruments registered or held directly or indirectly in the name of the depositary should be in custody. The last component of the definition concerns financial instruments provided as collateral. ESMA considers that financial instruments should not be held in custody when they have been provided as collateral under the terms of a title transfer financial collateral arrangement or under a security financial collateral arrangement by which the control or possession of the financial instruments within the meaning of Article 2(2) of Directive 2002/47/EC on financial collateral arrangements has been transferred from the AIF or the depositary to the collateral taker or a person acting on its behalf.
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 means registering the assets in its name in the first instance and, 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.

Oversight function

11. The AIFMD contains the same provisions regarding the depositary's oversight functions as those in 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 advice which clarifies 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). Finally, the advice 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 was 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's advice focuses 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 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. Where the depositary wishes delegate custody tasks to a third party, the third party must on an ongoing basis 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 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 the option of using '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.IV. Depositary functions

1 Depositary functions pursuant to §7 – Cash monitoring

Extract from the Commission's request

CESR is requested to advise the Commission on the conditions for performing the depositary functions pursuant to Article 21(7). 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.*

In its advice, CESR 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.

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.*

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.

1.1 Cash flow monitoring

Box 77

Cash Monitoring – general information requirements

Where an account is opened at a third party in the name of the AIF, 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, 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 at the 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. The form of the data flows and the frequency of transmission are defined in the contract appointing the depositary or in the service level agreement or similar document.

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 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;
 - 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 third party upon request of the AIFM to monitor the cash flows.
4. ESMA believes that the depositary should have a clear overview of all cash inflows and outflows in all instances. The 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.

Proper monitoring of all AIF's cash flows

To ensure the AIF's cash flows are properly monitored, the depositary should at least:

1. 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 credit institution of the non-EU market where cash accounts have been opened for the purpose of the AIF's operations;
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 and checking that the cash accounts opened in the name of the AIF, 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 are included in the reconciliation process;
5. monitor on an ongoing basis the outcomes and actions taken as a result of any discrepancies identified by the reconciliation procedures and alert the AIFM and/or the AIF if an anomaly has not been rectified without undue delay.
6. check the consistency of its own records of cash positions with those of the AIFM.

Explanatory text

5. Under Box 78, the depositary's obligations 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.

6. The requirement at Level 1 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 ESMA's advice, a conservative approach has been adopted by considering that this obligation should apply to all the AIF's cash rather than in the context of subscriptions only.

1.2 ESMA's justification for not providing further guidance in relation to the depositary's duties regarding subscriptions in the AIF

7. In its request, the Commission 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 out in Article 16 of that same Directive.
8. 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.
9. 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.
10. ESMA considers that it answers both questions in Box 78. 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.
11. With regard to the first question, ESMA has not put forward a specific requirement in its advice as it considers the obligations set out in the section on 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.
12. 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.
13. In accordance with the advice (see section on oversight duties, Box 84), 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.

2 Depository functions pursuant to §8 – Safe-keeping duties

Extract from the Commission's request

CESR is requested to advise the Commission on:

- *the type of financial instruments that shall be included in the scope of the depository'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 depository's books, and (ii) the financial instruments that can be 'physically' delivered to the depository;*
- *the conditions applicable to the depository 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 depository, including but not limited to:*
- *the conditions upon which such financial instruments shall be registered in a financial instruments accounts opened in the depository'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.*

CESR is requested to advise the Commission on:

- *the type of 'other assets' with respect to which the depository 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 depository pursuant paragraph to Article 8(a);*
- *the conditions applicable to the depository 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.*

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

- *the conditions upon which the depository 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 depository may rely in order to be satisfied that the AIF or the AIFM on behalf of the AIF holds the ownership of such as-*

- sets, and the means by which such information shall be made available to the depository;
- the conditions upon which the depository shall maintain a record of these assets, including but not limited to the type of information to be recorded according to the various specificities of these assets; and the conditions upon which such records shall be kept updated.

In 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 depository to perform its safekeeping duties accordingly.

2.1 Definition of the financial instruments that should be held in custody

Box 79

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 depository’s custody function when they meet all three of the criteria below:

1. they are transferable securities (including those which embed derivatives in accordance with Article 51(3), final sub-paragraph of Directive 2009/65/EC and Article 10 of Directive 2007/16/EC), money market instruments or units of collective investment undertakings (as listed in Annex I, Section C of Directive 2004/39/EC) ;
2. they have not been provided as collateral under the terms of a title transfer financial collateral arrangement or under a security financial collateral arrangement by which the control or possession of the financial instruments within the meaning of Article 2(2) of Directive 2002/47/EC on financial collateral arrangements has been transferred from the AIF or the depository to the collateral taker or a person acting on its behalf; and
3. they are registered or held in an account directly or indirectly in the name of the depository.

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 depository or the instrument is registered or held in an account directly or indirectly in the name of the depository.

Any financial instruments received as collateral for the benefit of the AIF should be regarded as having been ‘entrusted to the depository for safekeeping’ within the meaning of Article 21 (8) (a) and therefore fall within the scope of its custody duties.

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

14. The 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).
15. The 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. The approach taken in ESMA’s advice explicitly excludes 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, except where those instruments are registered or held in an account directly or indirectly in the name of the depositary (e.g. registered shares in Germany).
16. ESMA’s preferred approach consists of a simple definition by which all financial instruments registered or held in an account directly or indirectly in the name of the depositary²⁷ 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). In all instances, the registrar is not to be considered as a sub-custodian under the meaning of the Directive and its implementing measures.
17. In setting out the list of instruments that would fall within the depositary’s custody obligation under Box 79, ESMA has taken into account the relatively broad scope of the Level 1 text (which refers to ‘financial instruments that can be registered in a financial instruments account opened in the depositary’s books’) and the definition of ‘financial instruments’ in Directive 2004/39/EC. ESMA is conscious that certain of the instruments in Annex I, Section C of MiFID have not traditionally been considered as assets to be held in custody in a number of jurisdictions (e.g. derivatives). In this context, the future Securities Law Directive may in due course address issues related to property rights and legal certainty of securities holding transactions, while under the European Market Infrastructure Regulation a list will be drawn up of derivatives that will have to be cleared via central counterparties. These two initiatives may add some value in helping to further specify which types of financial instrument – beyond transferable securities, money market instruments and units of collective investment undertakings – should fall within the scope of the depositary’s custody obligation. In the meantime, ESMA has clarified that for the purposes of Article 21(8), transferable securities that embed derivatives should be held in custody.
18. In accordance with the above 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;

²⁷ at the level of the settlement system or, where relevant, in the issuer’s register.

- financial contracts (e.g. derivatives other than those embedded in transferable securities for the purposes of article 21(8)(a));
 - 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 or they are not registered or held in an account directly or indirectly in the name of the depositary;
 - cash deposits;
 - investments in privately-held companies and interests in partnerships.
19. With respect to the issue of collateral provided by the AIF or AIFM on behalf of the AIF, 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 arrangement:
- (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
20. In order to promote convergence in national regulatory approaches, only collateral arrangements within the meaning of the Collateral Directive (or equivalent such arrangements in non-EU jurisdictions, where applicable) should be taken into account for the purposes of determining whether financial instruments provided as collateral should be held in custody.
21. ESMA recommends excluding from the scope of the depositary's custody duties financial instruments provided by the AIF under a financial collateral arrangement where there is a title transfer or under a security financial collateral arrangement by which the control or possession of the financial instruments within the meaning of Article 2(2) of Directive 2002/47/EC on financial collateral arrangements has been transferred away from the AIF or the depositary to the collateral taker or a person acting on its behalf.
22. ESMA's view is 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 when the right of re-use has not been exercised. Furthermore, the depositary's liability under Article 21(12) shall not be affected by the fact that the right of re-use has been exercised. Further, ESMA considers that where financial instruments are subject to a repurchase or lending agreement, they should generally not be considered as belonging to the AIF for the duration of the agreement and should be considered as 'other assets' as defined in Article 21 (8) (b).

23. The advice requested by the Commission addresses the issue of collateral provided by the AIF or AIFM on behalf of the AIF. For the sake of clarity, ESMA considers that any financial instruments received as collateral for the benefit of the AIF should be regarded as having been ‘entrusted to the depositary for safe-keeping’ within the meaning of Art. 21(8)(a) AIFMD.

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 on the depositary’s books opened in the name of the AIF or of the AIFM acting on behalf of the AIF in order to be identified at all times as belonging to the AIF in accordance with Article 21(8)(a)(ii);
 - (b) maintain their records and accounts in a way that ensures their accuracy, and in particular their correspondence to the financial instruments and cash held for AIFs;
 - (c) conduct, on a regular basis, reconciliations between its internal accounts and records and those of any third parties by whom those assets are held;
 - (d) exercise due care in relation to the financial instruments held in custody to ensure a high level of protection;
 - (e) assess and monitor all relevant custody risks throughout the custody chain and inform the AIFM of any material risk identified; and
 - (f) 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.
2. Where the depositary has delegated its custody functions, the depositary would remain subject to the requirements of §1 (e) and would further have to ensure the third party (hereafter referred to as the ‘sub-custodian²⁸’) complies with §1 (d) as well as with the segregation obligations set out in Box 90.
3. In order to avoid potential circumvention of the requirements of the Directive, the depositary’s safekeeping duties set out in paragraphs 1 and 2 apply 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.

Explanatory text

²⁸ See definition in footnote 21 above

24. 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. Some respondents to the consultation sought clarification on the meaning of 'due care'. ESMA considers that this obligation requires the depositary, inter alia, to: know which custodians constitute the custody chain; understand the relevant risks that exist at each level of the chain; ensure that the due-diligence and segregation obligations have been imposed throughout the chain (from delegate to delegate) at a contractual level; ensure that it has appropriate right of access to the books and records of the sub-custodian as well as any of its delegates to ensure compliance with these requirements; and document all of the above, make these documents available to and report to the AIFM.
25. Whenever the AIF has set up a legal structure between itself 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. For that purpose, the depositary must apply the safe-keeping rules in Box 81 to the underlying assets of financial and/or legal structures controlled directly or indirectly by the AIF.

Box 81

Safe-keeping 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 ownership right over the assets of the AIF or of the AIFM acting on behalf of the AIF.
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.

In order to comply with that obligation, the depositary should be required to:

- (a) register in its record, in the name of the AIF, assets, including their respective notional amounts, for which it is satisfied the AIF or the AIFM acting on behalf of the AIF holds the ownership of those assets; and
- (b) ensure it is able to provide at any time a comprehensive and up-to-date inventory of the AIF's assets, including their respective notional amounts.

To that end, the depositary should:

(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 and positions from the relevant third party on a timely basis.

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 resulting in the issue of more assets 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.

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).
5. The depositary's safe-keeping obligations set out in paragraphs 1-4 apply 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.

Explanatory text

26. For all assets that do not fall under the definition of financial instruments to be held in custody as set out in Box 79, the depositary is first required to verify the right of ownership of the AIF or the AIFM acting on behalf of the AIF.

27. ESMA considers that cash should fall under the scope of 'other assets' in accordance with Article 21(8)(b). The depositary should therefore apply the provisions of Box 81 to the cash that it holds to the extent possible; for this purpose, the depositary should at least maintain a record of the cash belonging to the AIF, check the consistency between the positions in its records with those of the AIFM and set up and implement an escalation process for situations where an anomaly is detected.

28. Some respondents to the consultation called for a materiality threshold to be introduced in order to cover only 'significant' assets and exclude ancillary assets. As the Level 1 text makes no distinction of this kind, ESMA does not consider it appropriate to introduce one in its advice. Any such distinction would also be likely to lack clarity and lead to uncertainty over which assets should be covered. ESMA has therefore confirmed its approach, which requires the depositary to have a comprehensive overview of the AIF's assets at all times.

29. Some respondents to the consultation 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 setting out practical examples of appropriate evidence of ownership. 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 it 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. ESMA recognises that a broad range of entities could potentially be in a position to provide evidence of ownership.

30. ESMA considers that assets of the AIF that are provided as collateral should be subject to the safekeeping duties related to 'other assets'.
31. 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. For this purpose, the depositary must apply the safe-keeping rules in Box 81 to the underlying assets of financial and/or legal structures controlled directly or indirectly by the AIF. In carrying out these safe-keeping duties the depositary may rely on legal opinions and appropriate documentary evidence, which could include evidence from accredited auditors with local expertise, to verify ownership of the AIF or AIFM acting on behalf of the AIF.
32. The depositary is then required to maintain a record of all assets for which it is satisfied the AIF holds ownership.
33. ESMA has defined a pragmatic approach taking into account the different types of asset with which depositaries of AIFs can be entrusted and suggests requiring the depositary to register the assets in its own name and rely on timely information provided by third parties with a view to knowing 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.
34. 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).
35. 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. Provision of prior information of the depositary may be more 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 requirements are designed for AIFs with more frequent portfolio trading, for example investments in derivatives both on- and off-exchange. 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.
36. 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.

Reporting obligations for prime brokers

1. Where the AIFM has appointed a prime broker, it must ensure that the prime broker makes available to the depositary of the AIF a statement in a durable medium:
 - (a) showing the value at the close of each business day of the items in (3); and
 - (b) detailing any other matters which the prime broker considers are necessary to ensure the depositary of the AIF has up-to-date and accurate information about the value of assets the safekeeping of which has been delegated.
2. The statement must be made available to the depositary of the AIF not later than the close of the next business day to which it relates.
3. The statement must include:
 - (a) the total value of assets held by the prime broker for the AIF;
 - (b) the value of each of the following:
 - (i) cash loans made to the AIF and accrued interest;
 - (ii) securities to be redelivered by the AIF under open short positions entered into on behalf of the AIF;
 - (iii) current settlement amount to be paid by the AIF under any futures contracts;
 - (iv) short sale cash proceeds held by the prime broker in respect of short positions entered into on behalf of the AIF;
 - (v) cash margin held by the prime broker in respect of open futures contracts entered into on behalf of the AIF;
 - (vi) mark-to-market close-out exposure of any OTC transaction entered into on behalf of the AIF;
 - (vii) total secured obligations of the AIF against the prime broker; and
 - (viii) all other assets relating to the AIF.
 - (c) total collateral held by the prime broker in respect of secured transactions entered into under a prime brokerage agreement, including where the prime broker has exercised a right of use in respect of the AIF's assets;
 - (d) a list of all the institutions at which the prime broker holds or may hold cash of the AIF.

Explanatory text

37. The requirements in Box 82, which apply where prime brokers have been appointed by the AIF or the AIFM, took as a starting point the reporting requirements imposed by the UK FSA. There was strong support from respondents to the consultation for the introduction of similar requirements at EU level.

3 Depository functions pursuant to §9 – Oversight duties

Extract from the Commission’s request

CESR is requested to advise the Commission on the conditions the depository must comply with in order to fulfil its duties pursuant to Article 21(9). The advice shall include all necessary elements specifying the depository 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 83

Oversight duties – general requirements

1. At the time of its appointment, the depository 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 appropriate to the AIF and the assets in which it invests. Such procedures should be regularly updated.
2. To comply with its oversight duties under Article 21(9), the depository 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 depository should in all circumstances ensure an appropriate procedure exists which is implemented and frequently reviewed.
3. The depository 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.
4. The AIFM should ensure the depository 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 depository 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) and/or to review reports and statements of recognised external certifications by qualified independent auditors or other experts to ensure the adequacy and relevance of the procedures in place.

Explanatory text

38. Some respondents to the consultation underlined that the depository’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 depository was dependent on the AIFM providing up-to-date versions of the AIF rules and/or instruments of incorporation.

39. 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).
40. A second general principle behind the 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). This explains why the depositary should in all circumstances ensure an appropriate procedure exists and is implemented within the AIFM or any other entity (e.g. an administrator, accountant). It should also review this procedure or ensure that the procedure is being frequently reviewed. This framework does not prevent depositaries, where deemed appropriate and in agreement with the AIFM, from conducting ex-ante verifications to discharge their duties.
41. 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.
42. 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.
43. The depositary's role and responsibilities in relation to oversight of third parties are without prejudice to the responsibilities of the AIFM under Article 20 of the Directive.

(a) Oversight duties related to subscriptions / redemptions

Box 84

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

44. The approach set out in Box 84 clarifies 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.

45. 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, 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.

46. While ESMA recognises that the requirements in Box 84 are more relevant for open-ended AIFs, the Directive makes no distinction between different types of AIF with respect to the oversight duties related to subscriptions and redemptions. ESMA has clarified, however, that the frequency of the depositary's checks should be proportionate to the frequency of subscriptions and redemptions. This should provide the necessary flexibility for the depositary to adapt its oversight to the specific characteristics of the AIF.

47. 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 Articles 22 (3) (a) and 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 AIFMD 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. 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.

48. 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, for example, compliance with applicable law and AIF rules regarding the sales on the secondary market. 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), the depositary would be required to ensure no units / shares are sold by any unit-holder / shareholder to 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 in the UCITS Directive have been reproduced in the AIFMD using 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 85

Clarifications of the depositary's oversight duties

Duties related to the valuation of shares / units (b)

1. In order to ensure that the value of the units or shares 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, the depositary should:
 - a) 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; and
 - b) ensure that the valuation policies and procedures are effectively implemented and periodically reviewed.
2. 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.
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 AIF/AIFM and ensure timely remedial action has been taken in the best interest of the AIF's investors.

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| <p>4. 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.</p> |
|---|

Explanatory text

49. In accordance with Article 19 of the AIFMD, the AIFM is fully responsible for the valuation process. As such, 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 section IV.VIII of the advice).
50. To that end, the depositary should be expected to take all reasonable steps 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.
51. 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.
52. 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 interests of investors.

(c) Oversight duties relating to the carrying out of the AIFM's instructions

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 national 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

53. ESMA views this oversight duty as the core of the depositary's ongoing oversight of the AIF and the duty for which there is an obvious need for clarification in order to establish a more harmonised framework across the EU.

54. 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 advice therefore sets out a general principle with which the depositary would have to comply to fulfil its duty under Article 21(9)(c), which consists of 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. For this purpose, and in line with paragraph 9 of Box 75, procedures should be in place governing situations in which the depositary should be informed, or where a prior agreement from the depositary is needed, in relation to modifications to the AIF's offering documents.

55. ESMA considers the depositary should, for example, check that the AIF's investments are consistent with its investment strategy as described in the AIF's rules and offering documents with a view to ensuring 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.

56. The depositary would be expected to adopt an ex-post approach and, where a breach is 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 advice do not prevent the depositary from adopting an ex-ante approach where it deems appropriate and in agreement with the AIFM.

(d) Oversight duties relating to the timely settlement of the transactions

Box 87

Clarifications of the depositary's oversight duties

Duties related to the timely settlement of transactions (d)

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

57. 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 88

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, once declared by the AIFM, 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; and
3. check the completeness and accuracy of dividend payments, once declared by the AIFM, and, where relevant, of the carried interest.

For the purposes of point 2 above, the AIF or the AIFM acting on behalf of the AIF should provide the depositary with all information on reserves expressed on the financial statements.

Explanatory text

58. 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.
59. 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.
60. ESMA considers that the depositary's duties under paragraphs 1 and 3 are only triggered once a decision has been made by the AIFM to distribute.

Section 2 Due diligence duties

Extract from the Commission's request

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(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.*

CESR is encouraged to develop a comprehensive template of evaluation, selection, review and monitoring criteria to be considered

Box 89

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 and custody risk). This assessment should particularly enable the depositary to determine the potential implication of the insolvency of the sub-custodian. Where the depositary becomes aware that the segregation of assets is not, or is no longer sufficient to ensure protection from insolvency of a sub-custodian in a specific jurisdiction, the depositary should notify the AIFM.
 - (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 reputation 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 in line with the requirements set out in Box 90; and
 - (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 unusual market conditions or where a risk has been identified, the frequency and the scope of the review should be increased.
2. The requirements in paragraph 1 apply mutatis mutandis to further sub-delegations by the sub-custodian.
 3. The depositary should monitor compliance with the prohibitions in Article 21(4) of the Directive.
 4. 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.
 5. The depositary shall take such measures, including terminating the contract, as are in the best interests of the AIF and its investors where the delegate no longer complies with the requirements.

Explanatory text

1. 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.
2. 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 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.
3. Pursuant to Article 21 (11), the depositary has to perform due diligence whenever it delegates any of its safekeeping functions, irrespective of 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.
4. With regard to the delegation of custody, ESMA considers that providing a list of due diligence tasks to perform would essentially constitute 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 applied during the selection and ongoing monitoring of the sub-custodian based on best market practice.

5. 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 with which it would be entrusted. 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.
6. Ongoing monitoring should mainly consist of 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.
7. 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 fosters a better understanding of the market by the depositary.
8. Finally, the Commission asked ESMA to develop in its advice a 'comprehensive template of evaluation, selection, review and monitoring criteria'. A majority of respondents to the consultation 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 provided 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 diligence. Furthermore, due diligence is fully documented by industry actors as the documentation is the basis for contractual liability when a problem arises.

Section 3 Segregation

Extract from the Commission's request

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 ongoing basis that the third party fulfils the conditions referred to in Article 21(11)(d)(iii).

Box 90

Segregation obligation for third parties to which depositaries have delegated part or all of their safekeeping functions (based on Article 16 of Directive 2006/73/EC)

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 (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;
 - (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 and the assets of its clients;
 - (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.
 - (f) 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.
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. The advice is based on the requirements set out in Article 16 of Directive 2010/43/EC. 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 in the AIFMD. In particular, the advice acknowledges that sub-custodians may use omnibus accounts, described in Recital 40 as ‘a common segregated account for multiple AIFs’.
3. Further, the segregation obligations apply both to financial instruments held in custody and to assets subject to record keeping.
4. §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 89 §1 (a). However, in some countries, the segregation requirements defined in the AIFMD may not be sufficient to protect the assets in case of insolvency. 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.
5. Taking into account useful feedback received to the consultation, ESMA has identified the following additional steps that could be taken by depositaries where the effects of segregation are not recognised by the local insolvency law:
 - making a disclosure to the AIF and AIFM so that this aspect of custody risk is properly taken into account in the investment decision;
 - taking such measures as possible in the local jurisdictions to make the assets as ‘insolvency-proof’ as possible based on local law advice;
 - undertaking appropriate levels of ongoing monitoring to ensure that the relevant sub-custodian continues to comply with the criteria for selection set out in line with paragraph 1(b)(iii) of Box 89 – this may involve an enhanced level of credit monitoring or enhanced levels of reconciliations work or other measures to pick up any early warning signals of potential problems;
 - using buffers;



- prohibiting temporary deficits in client assets;
- putting in place arrangements prohibiting the use of a debit balance for one client to offset a credit balance for another.

V.V. 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 ensuring a high level of investor protection while at the same time not putting the entire responsibility on the depositaries, as this would be potentially counterproductive by creating the incentive for regulatory arbitrage and in some cases leading 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 in case of 'loss' of the financial instruments in custody compared to the UCITS IV framework 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 would have been unavoidable despite all reasonable efforts to the contrary.
4. The ultimate objective of the implementing measures on 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 advice, ESMA provides 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, the advice 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. In order 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

Extract from the Commission's request

CESR 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, 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.

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.*

Box 91

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 of the AIF 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 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. To that end, the AIFM and the depositary 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 consultation stressed the importance of the notion of permanence when defining the loss. They added that there should be no prospect of recovering them, thus excluding situations where the assets are unavailable or temporarily frozen. For the majority of industry stakeholders, 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.
9. 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.
10. Therefore, in the first instance ESMA has set out the conditions to be met for financial instruments in custody to be considered 'lost'.
11. 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

12. 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’ due to 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.
13. For the two other types of situation, 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 the instruments on a permanent basis and not simply temporarily.
14. 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.
15. 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.
16. With respect to the assessment of whether instruments have been lost, the AIFM should 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. This communication should be made regardless of whether the depositary has been, or is subsequently held liable for the loss and obliged to return financial instruments of an identical type or the corresponding amount. 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.
17. 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 certainty that part of the financial instruments are lost, the AIFM should record that loss in its books. 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.
18. No particular mechanism has been defined to address situations where the depositary and the AIF or the AIFM have different views. 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

Extract from the Commission's request

CESR 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.*

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.

Box 92

Definition of 'external event beyond the depositary's reasonable control, the consequences of which would have been 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 is not 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 diligence, 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:

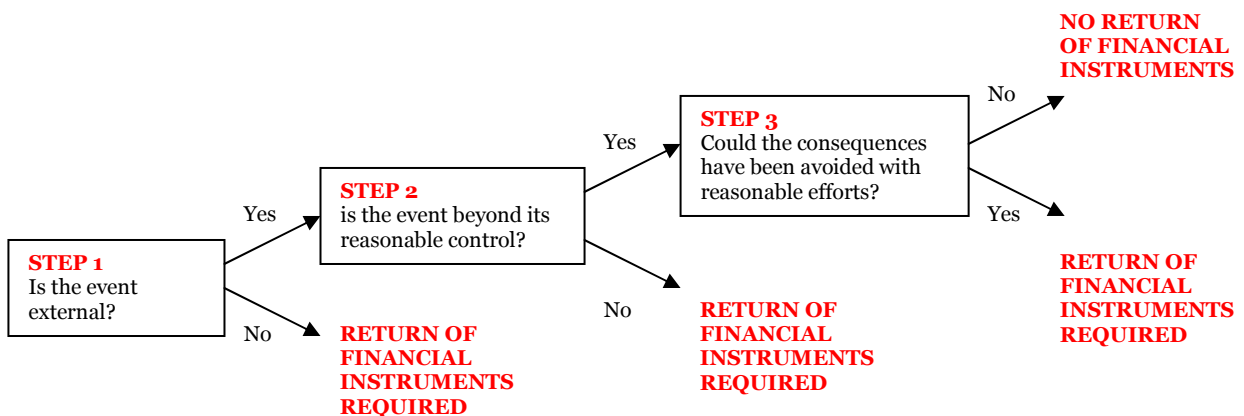
- (a) it has ensured that it has the structures and expertise that are adequate and proportionate to the nature and complexity of the assets of the AIF, to identify in a timely manner and monitor on an ongoing basis any external event it could reasonably identify which it considers may result in a loss 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; and
- (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

19. 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’.
20. Under the advice, each of the three elements is deemed necessary for the depositary to discharge its liability i.e. 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

21. The first step is to determine whether the event which led to the loss was ‘external’.
22. ESMA carefully considered the different types of event which could lead to a loss of financial instruments under custody, including on the basis of feedback from stakeholders, 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.
23. 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 (...)

24. 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.
25. 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.
26. 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 Securities Depository or any other settlement system should be considered 'external'.
27. 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.
28. 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

29. 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.
30. 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

31. 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 out 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.
32. 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.
33. 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 its liability.
34. 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 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.
35. 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 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

Extract from the Commission's request

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(13).

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 (13).

36. 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.

37. 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 93

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:

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. 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).

38. 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 signed, written contract between the depositary and the sub-custodian, which must define the 'objective reason' justifying this contractual transfer of liability.

39. 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.

40. The 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.
41. As set out in paragraphs 37-39 of the Explanatory text under Box 92, there may be situations where an AIFM insists on maintaining its investment in a particular jurisdiction despite warnings by the depositary of the increased risk this presents (e.g. in case of a possible nationalisation). In such circumstances, ESMA considers that there should be some flexibility in the interpretation of the two criteria set out in Box 93. For example, the AIFM may determine, having carefully weighed the potential return on a particular investment against the increased custody risks flagged by the depositary, that it is in the best interests of the AIF's investors to maintain the investment. This is clearly a judgement for the AIFM to make based on its role as the investment manager; however, in such circumstances ESMA is of the view that the depositary could reasonably be seen as having no choice but to delegate its custody to a third party (in line with the first criterion in Box 93). Similarly, the AIFM should consider whether it is in the best interests of the investors to allow the discharge in such circumstances (in line with the second criterion in the Box), bearing in mind that the alternative could be the procedure leading to termination of the contract foreseen in paragraphs 37-39 under Box 92.
42. Nevertheless, ESMA underlines that the AIFM and the depositary should not view the option to discharge liability to a third party as a convenient means to resolve possible disputes of the type set out above, and that there should be appropriate procedures in place to address such disagreements at an earlier stage.
43. 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)).

VI. Possible Implementing Measures on Methods for Calculating the Leverage 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 the consultation expressed a general disagreement with the gross method proposed made by ESMA for the calculation of the leverage. According to stakeholders, this method would not reflect the exact leverage of the AIF and would potentially provide misleading information to investors.
3. The feedback from the consultation showed more support for the commitment method that allows netting and hedging arrangements although there was a call for relaxing the rules applicable to these arrangements which were deemed to be too restrictive.
4. Many respondents saw the merit of the advanced method but would have preferred the use of Value-at-Risk (VaR) and asked ESMA to reconsider its position concerning this method. ESMA carefully analysed the different comments received during the consultation and decided not to change the approach for the calculation of the leverage. Indeed, ESMA strongly believes that information on the level of the gross leverage is of utmost importance in the context of the monitoring of systemic risk and that investors should also be provided with this information.
5. ESMA is of the opinion that further information on the level of the leverage based on the commitment method or on the advanced method would give competent authorities and investors a full picture of the leverage policy carried out by AIFM. Therefore, ESMA has retained these two methods in the final advice. As regards comments on the rules applicable to netting and hedging arrangement for the commitment method, ESMA recommends that they should be aligned to the rules applied by UCITS to take into account the fact that many AIFMs manage UCITS-like AIFs. Moreover, ESMA would like to stress that the advanced method which relaxes the rules of the commitment method was designed for AIFMs managing AIFs for which the commitment method may not be appropriate or may not provide meaningful results.
6. 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 the 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 AIFs use 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.

7. ESMA considers that it is important to highlight the context within which this advice is being provided. Specifically, ESMA notes the following obligations on AIFMs with respect to the use of leverage:
- the requirement for AIFMs to set out in their authorisation the ‘policy as regards the use of leverage’²⁹;
 - the requirement for the AIFM to set ‘a maximum level of leverage which they may employ on behalf of each AIF it manages’³⁰;
 - 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.’³¹
8. 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.
9. 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’)³². 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.
10. 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.
11. Some AIFMs will also be managing UCITS which will require them to follow the CESR Guidelines on the calculation of global exposure. The Commission 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 AIFMs that also manage UCITS.

²⁹ Article 7(3)a

³⁰ Article 15(4)

³¹ Article 25(3)

³² http://www.esma.europa.eu/data/document/10_788.pdf

12. 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.
13. 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.
14. ESMA would like to emphasise that the commitment approach under the CESR Guidelines can be calculated by most, if not all AIFMs; however, for some AIFMs the resulting figure for exposure may be misleading. Specifically, that approach has as its underlying assumption the concept that the relative 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.
15. The advice in this section sets out the methods that AIFMs 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 guarantees³³. The AIFM should also 'look through' financial derivative instruments or other instruments where leverage is embedded in the contract so as to convert to an equivalent underlying position.
16. ESMA considered the extent to which its advice should permit AIFMs 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 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.
17. 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.

Extract from the Commission's request

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

³³ 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.



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 14³⁴.

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.

³⁴ Now recital 78 in the version published in the Official Journal.

General Provisions on Calculating the Leverage of an AIF

1. The leverage of an AIF should be expressed as a ratio between the exposure of an AIF and its net asset value.
2. For the purpose of calculating the leverage of an AIF, AIFM shall calculate the exposure of the AIF in accordance with the Gross Method as set out in Box 95 and the Commitment Method as set out in Box 96.
3. In addition to calculating exposure under the Gross Method and Commitment Method, and upon notification to the competent authorities of its home Member State, AIFM may calculate the exposure of an AIF under its management in accordance with the Advanced Method set out in Box 97.
4. For the purpose of calculating the exposure according to the Gross Method, the Commitment Method and the Advanced Method, 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. For AIFs whose core investment policy is to acquire control of non-listed companies or issuers, AIFM should not include in the calculation of exposure any leverage that exists at the level of those non-listed companies and issuers.
5. 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. For the purpose of this paragraph, 'capital commitment' means the contractual commitment of an investor to provide the AIF with agreed amount of investment on request by the AIFM.
6. The notification referred to in paragraph 3 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 or after authorisation when applicable 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.
7. 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.
8. 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.
9. 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.
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 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 leverage.

11. 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.

Explanatory Text

18. 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 optional method that may be used by AIFM in certain circumstances.
19. ESMA considers that it is important to receive information about an AIF's exposure both on a gross and commitment basis. Specifically the degree to which overall exposure differs between the Gross Method and the Commitment Method may provide useful information. Competent authorities may seek to satisfy themselves that the netting and hedging arrangements are being applied in line with the CESR Guidelines.
20. 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.
21. 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 the AIFM 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.

22. 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.
23. 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.
24. ESMA considers that in interpreting the requirement in paragraph 4 of Box 94 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.

Box 95

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 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 are highly liquid investments held in the base currency of the AIF that are readily convertible to a known amount of cash, subject to an insignificant risk of changes in value and which provide a return no greater than the rate of the 3-month high quality government bond should be excluded from the calculation;
 - (b) financial derivative instruments should be converted into the equivalent position in their underlying assets using the conversion methods set out in Box 99;
 - (c) cash borrowings that remain in cash or cash equivalent as defined in paragraph 1 (a) and where the amounts of that payable are known should be excluded from the calculation;
 - (d) Exposure resulting from the reinvestment of cash borrowing should be included in the calculation and expressed as the maximum between the market value of the investment realised and the total amount of the cash borrowed; and
 - (e) positions within repurchase or reverse repurchase agreements and securities lending or borrowing agreements should be included in the calculation in accordance with paragraph 10 and paragraph 11 of Box 98.
2. When calculating the exposure of an AIF in accordance with the Gross Method AIFM should take into paragraphs 4 and 5 of Box 94.

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.
2. Cash and cash equivalents in the base currency of the AIF which are highly liquid investments held in the base currency of the AIF that are readily convertible to a known amount of cash, subject to an insignificant risk of changes in value and which provide a return no greater than the rate of the 3-month high quality government bond and 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 that are subject to an insignificant risk of changes in value and which provide with a return no greater than 3-month high quality government bond.
3. 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 use the conversion methods set out in the Box 99. These conversion methodologies are equivalent to the methodologies provided within the CESR Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (Ref. CESR/10-788). For example, this would mean the notional value of that options are delta adjusted³⁵.
4. 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 meant by 'temporary'. However, it is not the intention that AIFM include revolving credit facilities within this meaning.

³⁵ 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.

Commitment Method of Calculating the Exposure of an AIF

1. For the purpose of calculating the exposure of an AIF according to the commitment method, AIFM should:
 - (a) Convert each financial derivative instrument position into an equivalent position in the underlying asset of that derivative using the conversion methodologies set out in Box 99;
 - (b) Apply netting and hedging arrangements;
 - (c) Calculate the exposure created through the reinvestment of borrowings where such reinvestment increases the exposure of the AIF as defined in Box 98;
2. The exposure of an AIF under the commitment method will be the sum of (a) less (b) plus (c).
3. For the purpose of calculating the exposure of an AIF according to the commitment method, 'netting arrangements' and 'hedging arrangements' mean respectively the following:
 - (a) 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; and
 - (b) 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.
4. For the purpose of calculating the exposure of the AIF according to the commitment method, a financial derivative instrument is not taken into account if it fulfils all of the following characteristics:
 - (a) It swaps the performance of financial assets held in the UCITS portfolios for the performance of other reference financial assets;
 - (b) It totally offsets the market risk of the swapped assets held in the UCITS portfolio so that the UCITS performance (e.g. performance of the net asset value) does not depend on the performance of the swapped assets; and

- (c) It includes neither additional optional features, nor leverage clauses nor other additional risks as compared to a direct holding of the reference financial assets.
5. In addition to paragraph 2, a financial derivative instrument is not taken into account when calculating the exposure according to the commitment method if it meets both of the following conditions:
 - (a) The combined holding by the UCITS of a financial derivative instrument relating to a financial asset and cash which is invested in cash equivalent as defined in paragraph 1(a) of Box 94 is equivalent to holding a long position in the given financial asset.
 - (b) The financial derivative instrument is not considered to generate any incremental exposure and leverage or market risk.
 6. 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.
 7. Notwithstanding paragraph 6, 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.
 8. 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.
 9. 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 as set out in Box 100 hereunder.
 10. When calculating the exposure in accordance with the Commitment Method, AIFM should take into account paragraphs 4 and 5 of Box 94.

Explanatory Text

26. 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.
27. A financial derivative instrument which meets the criteria in paragraph 4 above is meant to substitute the exposure of other reference financial assets for the exposure on financial assets directly held in the AIF portfolio. Furthermore, it does not subject the AIF to the market risk of the assets held as it totally protects the AIF from movements in the market value of these assets.
28. As an example, if the AIF portfolio invests in the DAX index and holds a financial derivative instrument which swaps the performance of the DAX index with the performance of the NIKKEI index then it must be equivalent to holding exposure to the NIKKEI index in the portfolio. So, the AIF net asset value does not depend on the performance of the DAX index.
29. As the financial derivative instrument does not provide any incremental exposure or leverage (i.e. exposure is created on an unleveraged basis) as calculated using the commitment approach, it will not have to be taken into account in the commitment approach calculation process. This reasoning can be extended to cases in which the performance swap involves several assets or even the entire portfolio.
30. As an illustration of paragraph 5 above, an AIF that invests in index future contracts and holds a cash position equal to the total underlying market value of future contracts, this is equivalent to directly investing in index shares and the use of these financial derivative instruments (i.e. index futures) does not provide any incremental exposure.
31. 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.
32. 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.

33. 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

34. 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.

35. 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.

36. 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).

37. It is possible to net a long position on share xyz with a put option on that same share xyz.

Hedging

38. 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.

39. 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, EONIA³⁶) 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.
40. 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 paragraph 2 of Box 95 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 2 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 2 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 exposure as criterion (d), under point 6 of Box 96 above, is not complied with.

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:

³⁶ Euro OverNight Index Average

- (a) take into account paragraphs 4 and 5 of Box 94;
 - (b) calculate exposure for each financial derivative instrument position with reference to the Commitment Method in accordance with Box 95 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. For the purpose of calculating the exposure according to the Advanced Method, '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.
3. 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

41. 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.

42. 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 3 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.

43. 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.

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. Therefore, the exposure must be greater of the value of the investment realised with the borrowing and the total amount of the borrowing. However, to avoid doubling counting cash borrowings that are used to finance exposure should not be included within the calculation.
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 or cash equivalent as defined in Box 94 Paragraph 1 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. The same treatment must be applied to Financial Spread Bets.
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 market value of the equivalent underlying asset. This may be replaced by the notional value of the contract where this is more conservative.
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. The same approach must be adopted for embedded derivatives, e.g. in structured products. The structure should be broken down into its component parts and the effect of layers of derivative exposures must be adequately captured.
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 order to generate a return greater than the financing cost incurred. This reinvestment of 'cash collateral' means that incremental 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 will be reinvested. 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 security-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 security to a security-borrowing counterparty (who will normally borrow security to cover a physical short sale transaction) for an agreed fee. The security borrower will deliver either cash

or non-cash collateral to the AIF. Only where cash collateral is reinvested in instruments other than those defined in Box 94 Paragraph 1 (a) will global exposure be created. If the non-cash collateral is further used as part of a repo or another security 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 securities will borrow security from a security-lending counterparty for an agreed fee. The AIF will then sell the security in the market. The AIF is now short that security. 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 securities; additional exposure is created to the extent that that cash received is reinvested.
14. **Credit Default Swaps:** For protection seller, the exposure is the higher of the market value of the underlying reference assets or the notional value of the Credit Default Swap. For protection buyer, the exposure, the exposure is the market value of the underlying reference asset.

Explanatory Text

44. 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.

Box 99

Conversion methodologies for financial derivative instruments

1. The following conversion methods should be applied to the non-exhaustive list of standard derivatives below.
 - Futures
 - Bond Future:
Number of contracts * notional contract size * market price of the cheapest-to-deliver reference

bond

- Interest Rate Future:

Number of contracts * notional contract size

- Currency Future:

Number of contracts * notional contract size

- Equity Future:

Number of contracts * notional contract size * market price of underlying equity share

- Index Futures:

Number of contracts * notional contract size * index level

- Plain Vanilla Options (bought/sold puts and calls)

- Plain Vanilla Bond Option:

Notional contract value * market value of underlying reference bond * delta

- Plain Vanilla Equity Option:

Number of contracts * notional contract size * market value of underlying equity share * delta

- Plain Vanilla Interest Rate Option:

Notional contract value * delta

- Plain Vanilla Currency Option:

Notional contract value of currency leg(s) * delta

- Plain Vanilla Index Options:

Number of contracts * notional contract size * index level * delta

- Plain Vanilla Options on Futures:

Number of contracts * notional contract size * market value of underlying asset * delta

- Plain Vanilla Swaptions:

Reference swap commitment conversion amount (see below) * delta

- Warrants and Rights:

Number of shares/bonds * market value of underlying referenced instrument * delta

- Swaps

- Plain Vanilla Fixed/Floating Rate Interest Rate and Inflation Swaps

Market value of underlying

- Currency Swap:

Notional value of currency leg(s)

- Cross currency Interest Rate Swaps:
Notional value of currency leg(s)

- Basic Total Return Swap:
Underlying market value of reference asset(s)

- Non-Basic Total Return Swap:
Cumulative underlying market value of both legs of the TRS

- Single Name Credit Default Swap:
Protection Seller – The higher of the market value of the underlying reference asset or the notional value of the Credit Default Swap.
Protection Buyer – Market value of the underlying reference asset

- Contract for Differences:
Number of shares/bonds * market value of underlying referenced instrument

- Forwards

- FX forward:
notional value of currency leg(s)

- Forward Rate Agreement:
notional value

- Leveraged exposure to indices or indices with embedded leverage

A derivative providing leveraged exposure to an underlying index, or indices that embed leveraged exposure to their portfolio, must apply the standard applicable commitment approach to the assets in question.

2. The following conversion method should be applied to the non-exhaustive list below of financial instruments which embed derivatives

- Convertible Bonds:
Number of referenced shares * market value of underlying reference shares * delta

- Credit Linked Notes:
Market value of underlying reference asset(s)

- Partly Paid Securities:
Number of shares/bonds * market value of underlying referenced instruments

- Warrants and Rights:
Number of shares/bonds * market value of underlying referenced instrument * delta

3. The following instruments are given as examples of non-standard derivatives with the related commitment methodology to be used.

- Variance Swaps

Variance swaps are contracts that allow investors to gain exposure to the variance (squared volatility) of an underlying asset and, in particular, to trade future realized (or historical) volatility against current implied volatility. According to market practice, the strike and the variance notional are expressed in terms of volatility. For the variance notional, this gives:

$$\text{variance notional} = \frac{\text{vega notional}}{2 \times \text{strike}}$$

The vega notional provides a theoretical measure of the profit or loss resulting from a 1% change in volatility.

As realised volatility cannot be less than zero, a long swap position has a known maximum loss. The maximum loss on a short swap is often limited by the inclusion of a cap on volatility. However without a cap, a short swap's potential losses are unlimited.

The conversion methodology to be used for a given contract at time t is:

Variance Notional * (current) Variance_t (without volatility cap)

Variance Notional * min [(current) Variance_t; volatility cap²] (with volatility cap)

whereby: (current) variance_t is a function of the squared realized and implied volatility, more precisely:

$$(\text{current}) \text{ variance}_t = \frac{t}{T} * \text{realized volatility } (0,t)^2 + \frac{T-t}{T} * \text{implied volatility } (t,T)^2$$

- Volatility Swaps

By analogy with the variance swaps, the following conversion formulae should be applied to volatility swaps:

Vega Notional * (current) Volatility_t (without volatility cap)

Vega Notional * min [(current) Volatility_t; volatility cap] (with volatility cap)

Whereby the (current) volatility_t is a function of the realized and implied volatility.

4. Barrier (knock-in knock-out) Options

Number of contracts * notional contract size * market value of underlying equity share* delta

Explanatory Text

45. CESR published in July 2010, guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (CESR/10-788) which set out conversion methodologies for derivative instruments. ESMA considers that AIFM, when calculating the total value of assets under management and the leverage of their AIFs, should use the same conversion methods as presented in Box 99 above.

Box 100

Duration netting rules

1. The duration-netting rules cannot be used if it would lead to an incorrect assessment of the risk profile of the AIF. AIF availing of these netting rules should not include other sources of risk (e.g. volatility) in their interest rate strategy. Therefore, for example, interest rate arbitrage strategies may not apply these netting rules.
2. The use of these duration-netting rules cannot generate any unjustified level of leverage through investment in short-term positions. Thus, for example, short-dated interest rate derivatives cannot be the main source of performance for a AIF with medium duration if it makes of this netting methodology.
3. A AIF interest rate derivative should be converted into its equivalent underlying asset position according to the following methodology:
 - a) Allocate each interest rate financial derivative instrument to the appropriate range ('bucket') of the following maturity-based ladder:

Bucket	Maturities range
1	0 - 2 years
2	2 - 7 years
3	7 - 15 years
4	> 15 years
 - b) Calculate the equivalent underlying asset position of each interest rate derivative instrument as its duration divided by the target duration of the AIF and multiplied by the market value of the underlying asset:

$$\text{Equivalent underlying asset position} = \frac{\text{duration}_{FDI}}{\text{duration}_{\text{target}}} \times \text{MtM}_{\text{Underlying}}$$

where:

- $duration_{FDI}$ is the duration (sensitivity to interest rates) of the interest rate derivative instrument;
 - $duration_{target}$ is in line with the investment strategy, the directional positions and with the expected level of risk at any time and will be regularised otherwise. It is also in line with the portfolio duration under normal market conditions;
 - $MtM_{underlying}$ is the market value of the underlying asset as detailed in Box 98.
- c) Net the long and short equivalent underlying asset positions within each bucket. The amount of the former which is netted with the latter is the netted position for that bucket.
 - d) Net the amount of the remaining unnetted long (or short) position in the bucket (i) with the amount of the remaining short (long) position remaining in the bucket (i+1).
 - e) Net the amount of the unnetted long (or short) position in the bucket (i) with the amount of the remaining short (long) position remaining in the bucket (i+2).
 - f) Calculate the netted amount between the unnetted long and short positions of the two most remote buckets.
 - g) The AIF calculates its exposure as the sum of:
 - 0% of the netted position for each bucket;
 - 40% of the netted positions between two adjoining buckets (i) and (i+1);
 - 75% of the netted positions between two remote buckets separated by another one, meaning buckets (i) and (i+2);
 - 100% of the netted positions between the two most remote buckets; and
 - 100% of the remaining unnetted positions.
4. A AIF making use of the duration-netting rules can still make use of the hedging framework. However, only the interest rate derivatives which are not included in hedging arrangements can still make use of duration-netting rules

Explanatory Text

46. CESR published in July 2010, guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (CESR/10-788) which set out clear methodologies for the calculation of the exposure. In particular, these guidelines provide with duration-netting rules which ESMA considers that AIFM should also use when calculating the exposure of the AIF under paragraph 9 of Box 96.
47. As the commitment method wrongly leads to interest rates with different maturities being considered as different underlying assets, some AIFs may need to use specific netting rules which allow partial duration netting.
48. When identifying its investment strategy and risk profile, a AIF should be able to define the level of the interest rates risk and consequently to assess its target duration (as duration means the

portfolio market value sensitivity to interest rate movements). AIF should take into account the predefined target duration when making its investment choices. This means that the portfolio duration should be around the target duration under normal market conditions. Under a stressed market, the portfolio duration may diverge from the target duration. The portfolio composition should be modified in order to regularise this spread.

49. For each interest rate derivative instrument, the equivalent underlying asset position stands for the amount that would need to be invested in a cash asset in order to have the same risk profile as the aggregate risk profile of the interest rate derivative instrument held by the AIF. Consequently, the cash asset is taken to be a bond with a duration which is equal to the target duration of the AIF.
50. The maturities suggested to be the thresholds of the buckets (2 years, 7 years and 15 years) have been chosen in such a way that the buckets would surround the main issuing maturities on the bond market (5, 10 and 30 years).
51. The method used allows netting long positions with short positions whose underlying assets are different interest rates (e.g. 1 year vs. 2 years).
 - a) within each bucket, netting positions is totally accepted.

For instance, the AIF may invest in the derivative instrument with the closest maturity to the one it aims to hedge for liquidity issues, and a long position on an interest rate derivative instrument with a 18 months maturity may be matched with a short position on an interest rate derivative instrument with a 2 years maturity because of its low liquidity in the bond market.

- b) netting positions between two different buckets is partially allowed.

Netting long and short positions whose underlying assets have a large maturity spread is only partially allowed between different zones. Indeed, positions whose modified duration is much higher than the whole portfolio's modified duration are not in line with the investment strategy of the AIF and totally matching them should not be allowed. For instance, it would not be appropriate to match a 18 months maturity short position (set in zone 1) with a 10 years maturity long position (set in zone 3), the target duration of the AIF being around 2.

52. Some penalties have to be applied to the netted positions to allow only for partial netting and are expressed by means of percentages relying on the average correlations between the maturity buckets for 2 years, 5 years, 10 years and 30 years of the interest rate curve.
53. In fact, the bigger the time-band spread between the positions, the more that netting them must be subject to a penalty, which explains why these percentages increase with the distance between the zones.
54. Duration-netting rules may not be used for hedging purposes. As an example when calculating the exposure, AIF can firstly identify the hedging arrangements. And then, the derivatives involved in these arrangements are excluded from the global exposure calculation. AIF should use an exact calculation in hedging arrangements. ESMA believes that AIF should not use duration netting rules in the hedging calculation. The duration-netting rules may be used to convert the remaining interest rate derivatives into their equivalent underlying asset positions.

55. As an example, let us consider the following portfolio:

Portfolio

Instrument	Maturity	Notional	Amount	Sensitivity
Bond	4Y	650 000	1	3,79
IR Future	3Y	200 000	3	3,50
IR Future	4Y	75 000	-1	4,05
Bond Future	4Y	650 000	-1	3,80

56. The global exposure is calculated as follows:

- a) The long position on the bond of maturity 4Y is hedged by the short position on the bond future of the same maturity (lines in green). This hedging arrangement is thus excluded from the calculation of the global exposure.
- b) Then the duration-netting rules are applied to the remaining interest rates derivatives (IR future contracts of maturities 3Y and 4Y).

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 AIFMD 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 on-going 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. 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.
4. 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 securities³⁷. 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 risk³⁸.
5. 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 economy³⁹.

³⁷ Article 24(4)

³⁸ Article 24(5)

³⁹ Article 25(1)

6. 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 Board⁴⁰. 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 taken⁴¹.

Extract from the Commission’s request

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 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.*

CESR is also requested to advise on the appropriate timing of potential measures referred to in Article 25(3).

Box 101

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-

⁴⁰ Articles 25(2) and 53(1)

⁴¹ Article 25(7)

cles 25(3) and 25(4), they shall impose limits or other appropriate supervisory restrictions on the use of leverage by such AIFM⁴².

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

7. 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.
8. ESMA's 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:

⁴² 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.
9. Principles 1-4 in Box 101 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.
10. 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

11. 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).
12. 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.

13. 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.
14. ESMA's views on the approach to the timing of any supervisory measures are set out in Principle 5 of our advice.

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.’*⁴³ 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, on-going 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.

⁴³ [The Framework for the Preparation and Presentation of Financial Statements](#), paragraph 12

VIII.I. Possible Implementing Measures on Annual Reporting

1. ESMA was requested to advise the Commission on the content and format of the Directive's annual reporting provisions. ESMA was 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 was also 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. Respondents to the consultation expressed general support for ESMA's proposal regarding annual reporting obligations. However, some of them asked ESMA to clarify whether the requirement to produce an annual report applies to the AIFM or the AIF. Some stakeholders also disagreed with the presentation of unrealised gains in the primary financial statements which would be in contradiction with reporting practices in many countries.
4. 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.
5. 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.
6. 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.

7. 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.
8. 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.
9. ESMA draws the Commission's attention to the required scope of the implementing measures for Article 22. The 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 passport⁴⁴. 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 States⁴⁵.

Extract from the Commission's request

CESR 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.

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, 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.*

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, ESMA should specify in particular the elements and the level of detail of AIF's income and expenditure accounts.

⁴⁴ Article 42 read with Article 22.

⁴⁵ Article 34 (1)(a).

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, 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.*

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.

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.

Box 102

Annual Report Definitions

‘Material change’ (for the purposes of Article 22(2) (d) and with reference to Article 23, where appropriate) 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

10. 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.

11. 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’.

General Principles for the Annual Report

1. 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. The annual report shall contain the information investors may need in relation to particular AIF structures.

Explanatory Text

12. 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 2001,⁴⁶ 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.

Reporting Material Changes for the Annual Report

1. 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.
2. Where applicable, such information shall be disclosed in line with the requirements of the accounting standards and accounting rules adopted by the AIF together with a description of any potential or anticipated impact on the AIF and/or investors of the AIF. Additional disclosures shall be made when compliance with the specific requirements of the accounting standards and accounting rules may be insufficient to enable investors to understand the impact of the change. Where the information has already been provided to existing and potential investors, they may be referred to the medium in which or where such detailed information has been made available.

⁴⁶ 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

3. Where the information required to be disclosed is not covered by the accounting standards applicable to an AIF, or its accounting 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

13. 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).
14. 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 accounting 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).

Box 105

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. 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,

but not limited to 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, but not limited to 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 to ensure compliance with the above.
3. Additional line items, headings and subtotals in the balance sheet or statement of assets and liabilities shall be presented 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. Each material class of similar items shall be presented separately. Individual items, if material, should be disclosed. Materiality should be assessed under the requirements of the accounting framework adopted.
5. The presentation and classification of items in the balance sheet or statement of assets and liabilities shall be retained 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. 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, but not limited to 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.
 - (iv) ‘Realised loss on investments’ representing loss on the disposal of investment;
 - (v) ‘Unrealised loss on investments’ representing loss on the revaluation of investments.
 - (b) ‘Net income/expenditure’ representing the excess of income over expenditure or expenditure over income as applicable.
- 7. 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 to ensure compliance.
- 8. Additional line items, headings and subtotals in the income and expenditure account shall be presented 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.
- 9. Each material class of similar items should be presented separately. Individual items, if material, shall be disclosed. Materiality shall be assessed under the requirements of the accounting framework adopted.
- 10. All items of income and expense shall be recognised in a given period in the income and expenditure account unless an accounting standard adopted by the AIF requires or permits otherwise.
- 11. The presentation and classification of items in the income and expenditure account shall be retained 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

15. 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.

16. 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.
17. 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.
18. 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.
19. 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.
20. 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.

Content and Format of the Report on Activities for the Financial Year

1. The Report on the Activities of the Financial Year 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. The information provided in the report should be consistent with national rules where the AIF is established.

Explanatory Text

21. 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.
22. 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.
23. ESMA's view is that this section should form part of the Management Report insofar as this is usually presented alongside the financial statements of the AIF.

Content and Format of Remuneration Disclosure

1. In accordance with Article 22(2) (e) of the AIFMD, AIFM shall made available for each EU AIF it manages and each AIF it markets in the Union an annual report that should contain information on the total amount of remuneration for the financial year, split into fixed and variable components.
2. In this annual report, it shall be specified whether the total remuneration disclosed in the AIF's Annual Report relates to :
 - (a) the total remuneration of the entire staff of the AIFM and indicate the number of beneficiaries; 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 and indicate the number of beneficiaries; or
 - (c) the proportion of the total remuneration of the staff of the AIFM attributable to the AIF and indicate the number of beneficiaries.
3. Where relevant, the total remuneration for the financial year should also mention the carried interest paid by the AIF.
4. 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, a description of how the allocation or breakdown has been provided should be included.
5. 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.

Explanatory Text

24. 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.
25. Further context may be provided 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. ESMA believes that in addition of remuneration disclosure, it may be appropriate for AIFM to provide 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 incentives created. In this context, guidance may be provided by ESMA when developing guidelines on remuneration policies as provided by

Article 13(2). 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 guidelines⁴⁷ 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.

26. Paragraph 4 of ESMA's advice seeks to ensure proportionate application of the Directive to avoid situations where for smaller AIFM disclosure of information would be required 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 to disclose information which may be proprietary or confidential to the AIFM.

⁴⁷ <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 on-going basis.
2. ESMA was 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 apply⁴⁸. 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 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 law⁴⁹.
4. Respondents to the consultation expressed a strong preference for option 1 as proposed by ESMA in relation to the disclosure of the risk profile of the AIF. In light of this feedback, option 1 was retained in the final advice but ESMA considered it appropriate to introduce some of the features of option 2.

Extract from the Commission's request

With respect to the disclosure obligations in Article 23(4) CESR is 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.*

CESR is requested to adapt its advice to the types of AIFM.

⁴⁸ Article 23 (6)

⁴⁹ Article 23 read with Article 42

2. *With respect to the disclosure obligations in Article 23(5), CESR is requested to advise the Commission on:*
- *the appropriate frequency of such disclosures;*
 - *the essential information, and the format thereof, to ensure an appropriate description of changes to the maximum level of leverage which the AIFM may employ on behalf of the AIF as well as any right of re-use of collateral or any guarantee granted under the leveraging arrangement; and the leverage measures or ratios, and the format thereof, to be used by the AIFM when disclosing the total amount of leverage employed by the AIF during the reporting period and at the end of the reporting period including those specified according to Article 4.*

Box 108

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, for each AIF it manages that is not an unleveraged closed-ended AIFs, 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.
7. AIFM shall ensure that periodic disclosures shall contain measures to assess any sensitivity in the AIF 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.

Risk management systems employed by the AIFM

8. 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.
9. 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

5. 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 AIFMD. 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’ should be considered as special arrangements where they achieve outcomes similar to those achieved by side pockets.
6. 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.
7. 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.
8. 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.
9. The frequency of disclosure should be consistent with the AIF’s periodic reporting to investors, for example, where AIFM provides 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

10. 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 decided to suspend redemptions in exceptional circumstances.

11. 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.
12. 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

13. 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.
14. 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.

Box 109

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 94 (Gross Method of Calculating the Exposure of the AIF), and, either Box 95 (Commitment Method of Calculating the Exposure of an AIF), or where applicable, Box 96 (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.
 - (e) the new methodology employed for the calculation of the exposure of the AIF according to the Advanced Method when it impacts the level of the maximum leverage used by the AIF

together with the reasons for the change in the procedure.

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.

Explanatory text

Disclosure of changes to the maximum level of leverage, to the rights of re-use of the collateral and to the nature of guarantees granted.

15. 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 or to the rights of re-use of the collateral and to the nature of guarantees granted. 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 Method 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.
16. The level of leverage should be calculated as the relevant exposure as determined in Boxes 94, 95 and 96 divided by the net asset value of the AIF.

Disclosure of the total leverage employed

17. 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.
18. 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.
19. ESMA believes that the disclosure of the total leverage employed should also be supplemented by other meaningful information for investors such as the minimum and the average level of leverage to which the AIF was subject during the reporting period.

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. The majority of respondents to the consultation disagreed with ESMA's proposal to require information on a quarterly basis for all AIFMs. Stakeholders were of the view that there should be a distinction in terms of potential systemic risks and that relatively small AIFMs or AIFs could not be treated in the same way as larger entities. The majority of respondents called for annual reporting obligations although there was some appreciation of the need to request information on a more frequent basis for certain AIFMs and AIFs. An alternative approach based on the amount of assets under management at the level of the AIFM was also suggested.
3. ESMA considered carefully the feedback received from various stakeholders and deemed appropriate to modify the advice, in particular the reporting frequency. In the final advice, ESMA recommends that the reporting frequency should depend on (i) the amount of assets managed by the AIFM for information to be reported at the level of the AIFM and (ii) on the size of each fund for AIF-related information. Box 110 below sets out the different thresholds to be applied.
4. ESMA also believes that there should be a separate reporting frequency based on the nature of the investment made by the AIFM. Therefore, the final advice recommends that AIFM shall, in respect of each unlevered AIF under its management which in accordance with its core investment policy invests in non-listed companies and issuers within the scope of Article 26(1) and 26(4) in order to acquire control, report the information under Article 24(1) and 24(2) on an annual basis.
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. Some respondents to the consultation asked ESMA to ensure as much as possible consistency with other initiatives in terms of reporting obligation to competent authorities. Indeed, some stakeholders stressed that it would be detrimental for AIFM operating globally to have to comply with very different reporting obligations. ESMA analysed carefully these comments and saw the merit of a level-playing field in terms of reporting obligations to competent authorities. Therefore, the final reporting template takes into account these comments and reflects ESMA's consideration to the issue of harmonisation of reporting obligation to competent authorities on a global basis.
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 the Commission's request

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'.

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*

The template should be sufficiently flexible to accommodate the different types, sizes and investment strategies of AIFM, without compromising the objective of effective supervision.

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).*

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 to the competent authorities of its home Member State the following information subject to the requirements in Paragraph 4:
 - (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 AIFs' investment strategies and their geographical and sector investment focus;
 - (b) the markets of which it is a member or where it actively trades;
 - (c) the diversification of the AIFs' portfolio including, but not limited to, their principal exposures and most important concentrations.
2. The information required under paragraph 1 shall be provided as soon as possible and no later than one month after the end of the relevant period. Where the AIF is a fund of funds this period may be extended by the AIFM by 15 days
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 subject to the requirements in Paragraph 4:
 - (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. AIFM shall report the information on the following basis:
 - (a) AIFM managing portfolios of AIFs whose assets under management calculated according to Box 1 are below the thresholds calculated in Article 3(2)(a) and (b) shall report the information in Paragraph 1 on an annual basis;
 - (b) AIFM managing portfolios of AIFs whose assets under management calculated according to Box 1 are above the thresholds calculated in Article 3(2)(a) and (b) but below EUR1.5bn shall report the information in Paragraph 1 and Paragraph 3 on a semi-annual basis for each of the EU AIF it manages and for each of the AIF it markets in the Union; and

(c) AIFM managing portfolios of AIFs whose assets under management as calculated to Box 1 are above EUR1.5bn shall report the information in Paragraph 1 and Paragraph 3 on a quarterly basis for each of the EU AIF it manages and for each of the AIF it markets in the Union;

5. AIFM subject to the requirements in point (b) above shall for each AIF whose assets under management, including any assets acquired through the use of leverage, is greater than EUR500mn report the information in Paragraph 1 and in Paragraph 3 on a quarterly basis in respect of that AIF.
6. AIFM shall, in respect of each unleveraged AIF under its management which in accordance with its core investment policy invest in non-listed companies and issuers in order to acquire control, report the information in Paragraph 1 and provide the information in Paragraph 3 on an annual basis.
7. As an exception to paragraph 4, the competent authority of the home Member State of the AIFM may deem it appropriate to require all or part of the information to be reported on a more frequent basis.
8. AIFMs managing one or more AIFs which they have assessed to be employing leverage on a substantial basis in accordance with Box 111 (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.
9. AIFMs shall provide the information specified under paragraphs 1, 3 and 8 in accordance with the pro-forma reporting template as set out in Annex V. However, where an AIFM is required by the competent authority of its member State to report information on a more frequent basis in accordance with paragraph 7 or information not included in that template, 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.
10. 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. 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.
10. 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 economy⁵⁰. 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.
11. 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.
12. 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).
13. 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 111

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 94 (Gross Method of Calculating the Exposure of the AIF) Box 95 (Commitment Method of Calculating the Exposure of an AIF) and, where applicable, Box 96 (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

⁵⁰ Article 25(1).

- 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 on-going 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 8 of Box 110 (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

14. 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.
15. 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.
16. 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 110, 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.

IX. Supervision

IX.I. Co-operation arrangements between EU and non-EU competent authorities for the purposes of Article 34(1), 36(1), and 42(1) of the AIFMD

Extract from the Commission's request

CESR is requested to advise the Commission on a common framework to facilitate the establishment of the co-operation arrangements with supervisory authorities from third countries in the different situations described above. CESR is requested to advise on the objectives, the parties and the scope of the co-operation arrangements. In relation to the arrangements for the purpose of systemic risk oversight referred to in Articles 36(1) and 40(1), they should cover, at least, the minimum information related to the potential systemic consequences of non-EU AIFM activity that competent authorities should exchange with their non-European counterparts, the procedure for the exchange of that information and the frequency of the exchange. CESR is encouraged to consider as a framework the reporting obligations laid down in Article 24 AIFMD.

CESR should take into account that, due to the non-binding nature of the administrative arrangements, they should have a limited scope (i.e. cannot create legal obligations), since they cannot be considered as international treaties.

CESR is encouraged to take into account the relevant international standards in this regard, in particular, the principles and standards related to the control of the potential systemic risk posed by AIFM of the International Organisation of Securities Commissions (IOSCO)'.

IX.II. Co-operation arrangements between EU and non-EU competent authorities as required by Articles 35(2), 37(7)(d) and 39(2)(a) of the AIFMD

Extract from the Commission's request

CESR is requested to advise the Commission on a common framework to facilitate the establishment of co-operation arrangements with supervisory authorities from third countries in the different situations described above. CESR is requested to advise on the objectives, the parties and the scope of the co-operation arrangements. These arrangements should cover:

- a) the modalities and conditions for the supervision of non-EU AIFM and funds and*
- b) the procedures for the exchange of information between the authorities involved.*

The aim of these co-operation arrangements should be to ensure the efficient co-operation between supervisors and the effective supervision of the third country AIFM and/or AIF.

CESR should take into account that due to the non-binding nature of the administrative arrangements they should have a limited scope (i.e. cannot create legal obligations), since they cannot be considered as international treaties.

CESR is encouraged to take into account the international standards in this regard, in particular, the principles regarding cross-border supervisory co-operation of the International Organisation of Securities Commissions (IOSCO).

Box 112

Co-operation arrangements between EU and non-EU competent authorities

1. The co-operation arrangement with the third country competent authority should be in writing and provide for:
 - a. exchange of information for supervisory purposes;
 - b. exchange of information for enforcement purposes;
 - c. the ability to obtain all information necessary for the performance of the duties provided for in the Directive;
 - d. the ability to carry out an on-site inspection where required for the exercise of the EU competent authority's obligations under the Directive. The on-site inspection should be performed directly by the EU competent authority or by the third country competent authority with the assistance of the EU competent authority.
2. The third country competent authority should assist the EU competent authorities where it is necessary to enforce EU legislation and national implementing legislation breached by the entity established in the third country.
3. Where specific reference is made to exchange of information for the purpose of systemic risk oversight, the arrangement should allow the EU competent authority to receive information on a regular basis as provided for in Box 110 in order to discharge its duties under the Directive.
4. The co-operation arrangements between EU and non-EU competent authorities as required by Articles 35(2), 37(7)(d) and 39(2)(a) of AIFMD should comply with paragraphs 1 to 3 above.

Explanatory text

17. Co-operation arrangements between EU and non-EU competent authorities as required by Article 34(1), 36(1) and 42(1) of AIFMD

1. The Directive grants rights with respect to entities established in third countries. In particular the following situations are provided for:
 - EU AIFMs managing non-EU AIFs which are not marketed in Member States;
 - EU AIFMs marketing non-EU AIFs in Member States without a passport; and
 - Non-EU AIFMs marketing EU or non-EU AIFs in Member States without a passport.

2. In order to ensure that these rights can be exercised in a way which is not detrimental to the protection of EU investors and to the stability of the European markets, the arrangements should ensure a regular flow of information for supervisory purposes, including for systemic risk oversight. It should also be ensured that enforcement can be performed if necessary. In this context, it is crucial to avoid creating an unlevel playing field which unduly favours entities established in third countries.
3. The agreement should be signed by the European competent authority(ies) and the local third country competent authority and could take the form of a MMoU centrally negotiated by ESMA. It should allow the European competent authority(ies) to exercise the powers conferred on to them by the Directive, taking into account the list of powers that they are entitled to exercise pursuant to Article 46 of the Directive.
4. The detailed content of the co-operation arrangements would be established by ESMA taking into account international standards and, in particular, the IOSCO Multilateral Memorandum of Understanding with respect to co-operation for enforcement purposes and, for supervisory purposes, the IOSCO Technical Committee Principles for Supervisory Co-operation (including the sample MoU).
5. A specific clause should be included in the arrangements in order to allow the transfer of information received from a third country authority to other EU competent authorities, to ESMA or to the ESRB as envisaged by the Directive.
6. The competent authority in the third country should be able to meet the standards of data protection requested by art. 25 and 26 of the Data Protection Directive⁵¹ as already provided for by Article 52 of the Directive. This includes additional confirmation of the ability of the relevant local authority to meet adequate standards (art. 25) or trigger a permitted case of derogations (art. 26) concerning the treatment of information that can be classified as personal information. The transfer of data may only be permitted under the conditions set out in Article 52 of the Directive.
7. As far as information which is necessary for the supervision for systemic risk purposes is concerned, it is important to ensure that the same information which is available for EU entities (EU AIFMs and AIFs) is available where relevant entities are established outside the EU. It may be worth mentioning that the information relevant for the systemic risk oversight in fact may have relevance both for the supervision of the AIFMs which are established within the EU and for the AIFs which are marketed within the EU territory. The draft content of the arrangement will be adapted to the specific situation taking into account the information which is deemed to be necessary for EU supervisory purposes.
8. It should be understood that in certain circumstances the information necessary for systemic risk oversight may need to be passed on to other EU competent authorities, to ESMA or to the ESRB.
9. The Directive refers to guidelines to be adopted by ESMA. ESMA will commit to adopt such guidelines by the time the Commission will complete the process for the issuance of Level 2 measures.

⁵¹ Directive 95/46/EC

10. Where marketing of the units is envisaged in a country other than that of the EU competent authority which is the reference authority, the agreement could be signed as a joint agreement between all the authorities involved.
11. The written agreements necessary for the purposes of co-operation under the Directive may be based on a template established by ESMA at EU level.
18. Co-operation arrangements between EU and non-EU competent authorities as required by Articles 35(2), 37(7)(d) and 39(2)(a) of AIFMD
 1. The request for advice covers the following situations:
 - EU AIFMs marketing non-EU AIFs with a passport in the EU;
 - Non-EU AIFMs authorised to manage EU AIFs and/or market AIFs in the EU with a passport; and
 - Non-EU AIFMs marketing in the EU non-EU AIFs with a passport
 2. Due account should be taken of Article 50(4) of the Directive, which foresees the transmission of relevant arrangements concluded by the home country regulator to the host country regulator as well as the right of the host competent authority to refer the matter to ESMA in case it believes that the arrangement is not in line with the relevant regulatory standards.
 3. The Directive does not allow for the operation of a mutual recognition system with third countries, particularly with respect to the authorisation of non-EU AIFMs. This implies that an authorisation must be granted under the implementing legislation of the relevant EU Member State and that the relevant authority will assume primary responsibility insofar as the supervision of the entity established in the third country is concerned.
 4. It may be worth mentioning in this respect that Article 37(7) expressly makes reference to appropriate co-operation arrangements being in place between the competent authorities of the Member State of reference, the competent authorities of the home Member State of the EU AIFs and the supervisory authorities of the third country where the non-EU AIFM is established, in order to ensure at least an efficient exchange of information that allows the competent authorities to carry out their duties in accordance with the Directive. These arrangements could take the form of a MMoU centrally negotiated by ESMA.
 5. It is the Directive itself which does not allow for a more lenient approach in case of entities established in third countries. Therefore, the detailed content of the agreement should duly take this into account.

IX.III. Co-operation and exchange of information between EU competent authorities

Extract from the Commission's request

CESR is requested to advise the Commission on the content of the level 2 measures on the exchange of information on the potential systemic consequences of AIFM activity. In particular CESR is requested to advise on what type of information could be exchanged among supervisors in order to facilitate supervisory co-operation in identifying potential systemic risks and risks to the orderly functioning of markets posed by AIFM individually or collectively, taking into account the reporting requirements on AIFM pursuant to Article 24.

CESR is requested to advise the Commission on a template, a data format, and the conditions of secured data transmission for the exchange of data among competent authorities. CESR is also requested to advise on the periodicity of the exchange of the information.

1. In the request for assistance from the European Commission it is specified that consideration should be given to the list of information to be requested pursuant to the implementing measures under Article 24 (Reporting obligations to competent authorities). ESMA has developed a pro-forma reporting template (see Annex V) with the list of relevant information to be communicated by AIFMs to competent authorities. The content of this information and the frequency of its reporting are specified further in Box 110. ESMA considers that the information required on the basis of those provisions represents the minimum set of information that should be exchanged between EU competent authorities with regard to the potential systemic consequences of AIFM activity.
2. As for the means to exchange secure information, ESMA is currently developing a system to comply with the requirements established in other pieces of EU legislation; the remaining aspects of the Commission's request (such as the data format and conditions of secured data transmission) will be addressed via the development of that system and, where relevant, of additional ESMA guidelines.

IX.IV. Member State of reference: authorisation of non-EU AIFMs – Opt-in (Article 37(4))

Extract from the Commission's request

CESR is requested to advise the Commission on the procedure to be followed by Member States when determining the Member State of reference in cases where there are several possible Member States of reference. This advice should discuss a number of alternatives. It should take the following aspects into account: legal certainty, risk of regulatory arbitrage and potential impact/costs on the AIFM, the investors in the AIF it manages, and the competent authorities involved'.

Box 113

Member State of reference: authorisation of non-EU AIFMs

1. In cases of conflict between competent authorities of several Member States, the Member State of reference should be identified taking into account the Member State in which the AIFM intends to develop effective marketing for most of its AIFs pursuant to Article 37(4) (h).
2. The competent authorities identified by non-EU AIFM as the potential authorities of reference should immediately upon reception of the request, and no more than three business days following the reception of the request, contact each other and ESMA in order to consult on whether any other EU competent authorities or ESMA could potentially be involved pursuant to Article 37(4).
3. Where other EU competent authorities could potentially be involved, ESMA should immediately inform them.
4. The information referred to in paragraph 2 above should include the submission made by the non-EU AIFM, including in particular the details referred to in the last subparagraph of Article 37(4).
5. Within one week of their initial consultation or, where applicable, of receipt of the information by the other EU competent authorities, all the relevant competent authorities should exchange their views and, subsequently, they should jointly take a decision on the identification of the Member State of reference.
6. ESMA should facilitate the agreement between the relevant competent authorities.
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.

Explanatory text

1. The Member State where the AIFM develops effective marketing for most of its AIFs should mean the Member State where the AIFM intends to target investors by promoting and offering, including through third party distributors, most of the AIFs. In order to determine where the effective marketing will take place, the following non-exhaustive criteria should be considered: i) the Member State where the distributors (and the AIFM in case of self-distribution) are going to promote most of the units; ii) the Member State where most of the targeted investors have their domicile; iii) the Member State in whose official language the offering and promotional documents are translated; and iv) the Member State where advertisements are most visible and frequent.
2. The procedure to be followed when a non-EU AIFM opts in to benefit from the EU marketing passport should be the same as for EU AIFMs set out in Box 3 of the advice.

Annex I – Commission’s provisional request to CESR for technical advice

http://ec.europa.eu/internal_market/investment/docs/alternative_investments/level2/mandate_en.pdf

Annex II – 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
<p>Option 1 adopted by ESMA in the advice</p> <p>Box 1, paragraph 1 and 2 of the advice</p>	<p>The proposed approach on the identification of AIFs under management is consistent with the capital requirements of the Directive.</p> <p>AIFM are not required to calculate the NAV of the AIFs. The value of assets under management should be calculated at least annually using the latest asset value calculation.</p> <p>AIFs investing in financial derivatives are treated in the same way as AIFs having long position.</p> <p>AIF investing in financial derivatives for hedging purpose only are not required to include these positions in the calculation of the total value of assets under management.</p>	<p>Because financial derivatives should be converted in an equivalent position in the underlying asset and taken for the market value, some AIFs investing extensively in financial derivatives may be obliged to seek for authorisation.</p>	

<p>Option 2 proposed by ESMA in the consultation paper</p> <p>Box 1, paragraphs 1 and 2 of the consultation paper.</p>	<p>The proposed approach on the identification of AIFs under management is consistent with the capital requirements of the Directive.</p> <p>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.</p> <p>Consistent approach to valuation in the Directive.</p>	<p>Some AIFs that today do not calculate NAV will be required to do so annually which implies an additional cost.</p> <p>AIFMs must allow for the competent authorities to access the data used to calculate assets under management.</p> <p>No transparency vis-à-vis investors and public required on the assets under management data.</p>	<p>Support from the industry as evidenced in the feedback on question 1-5 of the Discussion paper.</p> <p>Valuation rules are also subject to national regulation.</p>
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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
<p>Option 1 adopted by ESMA in the advice</p> <p>Box 1, paragraph 4 of the advice.</p>	<p>The benefits are that it will only consider the underlying assets under management while including any effects of leverage.</p>	<p>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.</p>	<p>Does not increase systemic risk. Support from the industry as evidenced in the feedback on question 12-13 of the Discussion paper.</p>
<p>Option 2 considered by ESMA when developing the advice</p> <p>Paragraph 2 of the introduction in page 17 of the consultation paper</p>	<p>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).</p>	<p>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.</p>	<p>Double counting of assets lead to small AIFM being required to seek authorisation and the illusion of systemic risk may be created.</p>

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
Option 1 adopted by ESMA in the advice Box 1, paragraph 3 of the advice	The proposal allows for the use of existing procedures and does not require the calculation of the net asset value	Not requiring more frequent monitoring or calculation of NAV could lead to AIFMs not seeking authorisation in due time.	
Option 2 presented in the consultation paper Box 1, paragraph 3 of the consultation paper	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.
Option 3 presented in the discussion paper Page 10, first bullet point of the discussion paper.	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.	

<p>Option 4 presented in the discussion paper</p> <p>Page 10, second bullet point of the discussion paper.</p>	<p>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.</p>	<p>For AIFMs that do not monitor their assets under management on quarterly basis, this new requirement will lead to additional costs.</p>	
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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
<p>Option presented in the discussion paper and adopted by ESMA in the advice</p> <p>Box 1, paragraph 6 of the advice.</p>	<p>AIFMs managing AIFs with temporarily fluctuating values will be able to take that into account.</p> <p>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.</p> <p>The requirement to monitor the thresholds reduces the risk of manipulation of assets under management in order to</p>	<p>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.</p> <p>Risk of the AIFM not seeking authorisation due to the misconception that the breach is temporary.</p> <p>Allowing for monitoring rather than calculation in between the yearly calculations could lead to an AIFM</p>	<p>Support from the industry as evidenced in the feedback on question 14-15 and 20-21 of the Discussion paper.</p>

	<p>avoid being required to seek authorisation under the Directive.</p> <p>Monitoring provides flexibility for the AIFM which reduces costs in comparison to calculation requirements.</p> <p>The three month window provides clarity to what is considered “of a temporary nature”</p> <p>The proposal also clarifies, through examples, which factors may or may not be taken into account for the assessment.</p>	<p>not being authorised.</p>	
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1.5. Box 2: 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
	<p>The proposal allows for using information already produced by the AIFM in relation to its clients when registering with the competent authorities.</p> <p>A specification simplifies the production of the information for AIFs that currently do not have an adequate offering document available.</p> <p>The proposed approach does not create a requirement on AIFs to produce an offering document, since it focuses on</p>	<p>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.</p>	<p>Support from the industry as evidenced in the feedback on question 16-19 of the Discussion paper.</p>



the specific information instead of naming a document.		
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1.6. Box 3: 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	<p>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.</p> <p>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.</p>	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”	<p>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.</p> <p>The requirement to submit all documents set out in Article 7 will simplify the process for the AIFM since</p>	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.	

	<p>it will not need to go through previously submitted documents in order to ensure that they are up to date.</p> <p>The requirement will also be beneficial for competent authorities since they will not need to go through previously submitted documents from the AIFM.</p>		
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2. Initial Capital and own funds

2.1. Box 5: 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
<p>Summary</p> <p>Potential risks arising from professional negligence to be covered by additional own funds or professional indemnity insurance</p>			

Option	Benefits	Costs	Evidence
<p>Option 1' (retained in the final advice)</p> <p>Principle Based definition followed by a non-exhaustive, indicative list of risks which must be covered</p>	<p>The list is non-exhaustive but provides the AIFM with indication on what is deemed as professional liability risk.</p> <p>The approach is consistent with listing risks in Annex X Directive 2006/48/EC but addresses risks specific to AIFM.</p> <p>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.</p>	<p>Depending on current insurance policies, extra costs for AIFM to adjust policies.</p>	<p>The listed risks have proved acceptable by part of AIFM and insurance industry according to several contacts.</p>
<p>Option 2</p> <p>Principle based definition with no indicative list</p>	<p>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.</p>	<p>No protection of investor's interests, hence fund managers might follow their own interests.</p> <p>Investors' claims may not be covered by insurance policies. Operational risk management framework of the AIFM may disregard material risks.</p>	

2.2. Box 6: 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
<p>Option 1 (retained in the final advice)</p> <p>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.</p>	<p>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.</p> <p>Mitigation of operational failures and liabilities is most relevant and of highest benefit for investors.</p>	<p>One-off costs for setting up policy and procedures and low costs for periodic review and maintenance to AIFM.</p>	<p>Operational risk management requirements for banks have proven necessary.</p> <p>Standards are already required in case of German open-ended fund management companies and have proven beneficial.</p>
<p>Option 2</p> <p>No operational risk management policies and procedures. No self-assessment of liability risk by AIFM.</p>	<p>No implementation costs to AIFM, no regulatory costs.</p>	<p>Higher risk of operational failures of the AIFM resulting in liabilities to investors, which the AIFM can potentially not cover.</p> <p>High risk to market integrity.</p>	

2.3. Box 7: Quantitative Own Funds requirement

Options	Benefits	Costs	Evidence
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<p>Option 1</p> <p>Adapting the requirements in Art. 102-103 of Directive 2006/48/EC, basically 15% of net income</p>	<p>Consistency with existing regulation for banks as similar operational risks may be expected with regard to asset management.</p> <p>High liability risk coverage and hence high protection of investor claims.</p>	<p>High costs due to high capital requirements.</p> <p>High administrative burden for start-up AIFM.</p>	
<p>Option 2 (retained in the final advice)</p> <p>Base additional own funds requirement on 'assets under management' in line with Article 9(3) of the AIFMD.</p> <p>0.0001 x AuM</p>	<p>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.</p>	<p>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.</p>	<p>Broad support by respondents to the consultation</p>

<p>Option 3</p> <p>Adjusting requirements of Directive 2006/48/EC via taking the additional variable 'assets under management' into account and overall lowering the percentages.</p> <p>$0.000015 \times \text{AuM} + 0.02 \times \text{relevant income}$</p>	<p>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.</p>	<p>One-off costs for setting up procedures for determine relevant income.</p> <p>Middle costs for maintaining reasonable own funds. Lower capital costs compared to option 1.</p>	
<p>Option 4</p> <p>Base additional own funds requirement on fixed overheads. Additional own funds is equal to 15% of the amount mandated by Article 9 paragraph 5.</p>	<p>The calculation of additional own funds builds on the existing requirements, rather than introducing an entirely new methodology.</p>	<p>Fixed overheads may not be an adequate approximation for the size of the AIFM and for professional liability risk.</p> <p>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.</p>	



2.4. Box 8 paragraph 1: Professional Indemnity Insurance

Options	Benefits	Costs	Evidence
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<p>*Option 1 (retained in the final advice)</p> <p>Specifying minimum requirements for insurance policies and eligible insurance undertakings</p>	<p>Minimum requirements for insurance companies avoid 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.</p> <p>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.</p> <p>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.</p>	<p>Higher premium as specific liability risks driving premia cannot simply be excluded.</p>	<p>General support from respondents to the consultation</p>
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<p>Option 2</p> <p>No requirements for policies and eligible insurance undertakings</p>	<p>High discretion and flexibility to AIFM for determining insurance policies.</p>	<p>No protection of investor's interests, hence fund managers might follow their own interests.</p> <p>Insurance undertakings may not be able to pay the claims.</p> <p>Investor's claims may be not covered by insurance policies.</p> <p>High risk to market integrity.</p>	
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2.5. Box 8 paragraph 2 and 3 Professional Indemnity Insurance

Options	Benefits	Costs	Evidence
<p>Option 1</p> <p>No minimum coverage specified for insurance policies</p>	<p>High discretion and flexibility to AIFM for determining coverage amounts.</p>	<p>No protection of investor's interests, hence fund managers might follow their own interests.</p> <p>Investor's claims may be not covered by insurance policies as coverage may be too low.</p>	

<p>Option 2</p> <p>Specifying minimum coverage for insurance policies in line with Art. 7 (b) of Directive 2006/49/EC</p>	<p>Consistency with existing regulation with regard to specific MiFID firms.</p>	<p>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.</p>	
<p>Option 3 (retained in the final advice)</p> <p>Specifying higher minimum coverage for insurance policies compared to Art. 7 (b) of Directive 2006/49/EC</p>	<p>Direct comparison with certain MiFID firms is not adequate, particularly as those are not required to maintain additional own funds.</p> <p>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.</p> <p>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 7 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.</p>	<p>Potentially higher minimum coverage amounts and hence potentially slightly higher premia.</p>	<p>Has been suggested by part of the AIFM industry after consulting insurance companies.</p>

2.6: Box 9 Combination of additional own funds and Professional Indemnity Insurance

Options	Benefits	Costs	Evidence
<p>Option 1</p> <p>Possibility to combine additional own funds and Professional Indemnity Insurance</p>	<p>Flexibility to AIFM for determining how to cover liability risk.</p> <p>Reducing the impact on the insurance market.</p>	<p>Possible uncertainty on how the risk will be covered.</p> <p>Additional efforts for AIFM to determine the respective amounts of additional own funds and Professional Indemnity Insurance.</p>	<p>Specific request coming from respondents to the consultation.</p>



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 (retained in the final advice) 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 (retained in the final advice) Adapting the UCITS L2 directive requirements and adding specific provisions applicable to specific types of AIFs	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 from industry 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 (retained in the final advice) Adapting the MiFID L2 directive requirements	Art. 40 L2 MiFID differentiates between professional and retail clients, therefore more adequate for AIFMD which addresses marketing only to professional investors.	Low incremental costs.	Evidence shows that MiFID rules for professional clients are sufficient for professional investors.

<p>Option 2</p> <p>Adapting the UCITS L2 directive requirements</p>	<p>Harmonised market standards for all investment funds.</p>	<p>High incremental costs for AIFM as well as higher supervisory costs because of more detailed obligations.</p>	
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3.4. Box 13 Selection and appointment of counterparties and prime brokers

Option	Benefits	Costs	Evidence
<p>Option 1 (retained in the final advice)</p> <p>Selection criteria for counterparties and prime brokers</p>	<p>Minimum standard for selection and appointment of counterparties and prime brokers.</p> <p>Minimization of default risk.</p> <p>Ensures investor protection, market integrity and financial stability.</p>	<p>Low incremental costs since qualified fund managers already follow similar market standards.</p>	<p>Lesson from financial crisis that without careful due diligence of counterparties high risk for the market as a whole.</p>
<p>Option 2</p> <p>No criteria</p>	<p>Large flexibility regarding the choice of counterparties; lower costs to industry because unregulated companies can become supplier of respective services.</p>	<p>Not all fund managers comply with market standards resulting in higher risks for the investor and for financial stability.</p> <p>Inferior legal assertiveness of investors.</p>	

3.5. Box 14 and 15 Execution of decisions to deal on behalf of the managed AIF (Box 14) and placing orders to deal on behalf of AIF with other entities for execution (Box 15)

Option	Benefits	Costs	Evidence
<p>Option 1 (retained in the final advice)</p> <p>Adapting the UCITS/MiFID L2 directive requirements and exempting specific types of assets</p>	<p>Consistency with existing regulation.</p> <p>Level playing field with other investment funds and financial intermediaries, e.g. investment firms.</p> <p>Enhanced competition.</p>	<p>Depending on respective national law extra costs for fund managers of non UCITS.</p>	<p>MiFID rules for best execution are a market standard and have proven beneficial.</p>
<p>Option 2</p> <p>Adapting the UCITS/MiFID L2 directive requirements and adding requirements for specific types of assets for which there are no different execution venues</p>	<p>Better investor protection.</p>	<p>Higher incremental costs and no added value compared to due diligence rules.</p> <p>Risk of unsuitable design of regulation.</p>	

3.6. Box 16 and 17: Handling of orders and aggregation and allocation of trading orders

Option	Benefits	Costs	Evidence
<p>Option 1 (retained in the final advice)</p> <p>Adapting the UCITS L2 directive requirements for all types of assets</p>	<p>Consistency with existing regulation for other investment funds and intermediaries.</p>	<p>Low incremental costs because of existing market standards.</p>	<p>UCITS rules for order handling are a market standard and have proven beneficial.</p>
<p>Option 2</p> <p>Deviating rules for assets other than financial instruments</p>	<p>Better fit to specific assets.</p>	<p>Risk of unsuitable design of regulation due to diversity of assets other than financial instruments.</p>	

3.7. Box 18: Inducements

Options	Benefits	Costs	Evidence
<p>Option 1 (retained in the final advice)</p> <p>Adapting the MiFID level 2 directive requirements for all types of assets</p>	<p>Consistency with existing regulation and equal treatment of all relevant market participants.</p>	<p>Incremental costs for adaptation of marketing structures.</p>	<p>MiFID rules for inducements are a market standard and have proven beneficial.</p>
<p>Option 2</p> <p>No inducement rules</p>	<p>More flexibility for marketing models.</p> <p>Maintenance of existing infrastructures and marketing models in the market.</p>	<p>Less efficient markets due to non-transparent marketing structures resulting in higher costs for investors.</p>	

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
<p>Option 1 (retained in the final advice)</p> <p>Adapting the MiFID/UCITS L2 directive requirements</p>	<p>Obligation for self-assessment of the AIFM in relation to identification and management of conflicts of interests should lead to enhancement of market integrity.</p>	<p>One-off costs for setting up policy and low costs for periodic review to AIFM.</p>	<p>Financial crisis showed conflicts of interests are source of mismanagement.</p>
<p>Option 2</p> <p>No conflicts of interests policy</p>	<p>No implementation costs to AIFM and no regulatory costs.</p>	<p>Less efficient markets due to intransparent organisational structures of AIFM resulting in higher costs for investors.</p> <p>High risk to market integrity.</p>	

4.2. Box 23: Recordkeeping of activities giving rise to detrimental conflicts of interest.

Options	Benefits	Costs	Evidence
<p>Option 1 (retained in the final advice)</p> <p>Adapting the Mi-FID/UCITS L2 directive requirements</p>	<p>Enables AIFM to demonstrate compliance with conflicts of interest rules.</p> <p>Enables supervisory authority to monitor compliance of AIFM.</p>	<p>Low running costs for recordkeeping by AIFM.</p>	<p>Feedback from the consultation highlighted some elements which were overly restrictive and have been removed in the final advice.</p>

4.3. Box 24: Strategies for the exercise of voting rights

Options	Benefits	Costs	Evidence
<p>Option 1 (retained in the final advice)</p> <p>Adapting the UCITS Level 2 directive requirements</p>	<p>Transparency for investors regarding voting strategies enhances investor confidence.</p>	<p>One-off costs for setting up policy and low costs for periodic review to AIFM.</p>	



<p>Option 2</p> <p>No requirement for transparent voting strategies</p>	<p>More flexibility to AIFM regarding exercise of voting rights.</p>	<p>Risk of exercise of voting rights to the disadvantage of investors.</p>	
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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
<p>Option 1 presented in the consultation paper and adopted by ESMA in the advice</p> <p>Specifying the outcome that the systems need to achieve</p>	<p>Provides for a harmonised approach to be taken across AIFM so that the systems that are put in place ensure the same regulatory outcome.</p> <p>Reduces the risk that an inappropriate system is placed on the AIFM just because it is included within the advice.</p> <p>This method would require the AIFM to assess the effectiveness of the system rather than follow a tick box approach.</p>	<p>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.</p>	<p>Targeted industry engagement.</p>

<p>Option 2 considered by ESMA when developing the advice</p> <p>Specifying the individual systems that need to be employed</p>	<p>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</p>	<p>Implementing new systems will result in cost and if they are not appropriate to the AIFM may not bring about any benefit.</p>	<p>Targeted industry engagement.</p>
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5.2. Box 27: specifying the appropriate frequency of review of the risk management system

Option	Benefits	Costs	Evidence
<p>Option 1 presented in the consultation paper and adopted by ESMA in the advice</p> <p>Define trigger events that <i>may</i> indicate a review is required</p>	<p>Easy to follow.</p> <p>It permits the frequency to vary between AIFM depending on the risks which is proportionate.</p> <p>The list is indicative.</p>	<p>Costs will relate to the risk management function monitoring when these trigger events have occurred or are about to occur.</p>	<p>Targeted industry engagement..</p>
<p>Option 2 considered by ESMA when developing the advice</p> <p>Define a set period</p>	<p>Also easy to follow and implement.</p>	<p>May either be too infrequent or too frequent which leads to increased costs for no benefit or does not cover the risks.</p>	<p>Targeted industry engagement</p>
<p>Option 3 considered by ESMA when developing the advice</p> <p>Define a trigger event and require a review for each time the event occurs</p>	<p>Also easy to follow.</p>	<p>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.</p>	<p>Targeted industry engagement.</p>

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
<p>Option 1 presented in the consultation paper and adopted by ESMA in the advice</p> <p>Conditions as defined in the advice</p>	<p>Alignment with UCITS, therefore same requirements for managers and consistency in procedures.</p> <p>Separation ensures internal control mechanism</p>	<p>Potential additional costs for AIFM for risk manager and internal reporting lines.</p>	<p>Input from bilateral discussions with stakeholders: 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.</p>
<p>Option 2 considered by ESMA when developing the advice</p> <p>No specification in addition to Level 1, up to AIFM</p>	<p>None</p>	<p>Cost of non-harmonisation; Different approaches among Member States.</p>	

<p>Option 3 considered by ESMA when developing the advice</p> <p>Risk management structured in the form of independent committees</p>	<p>Use of current industry practise for PE and RE managers.</p>	<p>Restructuring of existing committees might be necessary to ensure independence of risk management from portfolio management.</p> <p>More complex for authorities and investors to recognize the separation.</p>	<p>Input from bilateral discussions with stakeholders: 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.</p>
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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
<p>Option 1 presented in the consultation paper and adopted by ESMA in the advice</p> <p>Conditions as defined in the advice</p>	<p>Review of separation, governing body and investors need to be informed about potential conflicts of interest</p>	<p>Potential additional costs for AIFM arising from the involvement of governing body, targeting conflicts of interest, reporting to investors.</p>	<p>Easily applicable for hedge fund managers.</p>
<p>Option 2 considered by ESMA when developing the advice</p> <p>No specification in addition to Level 1, up to AIFM</p>	<p>None</p>	<p>Cost of non-harmonisation; Different approaches among Member States.</p>	

<p>Option 3 considered by ESMA when developing the advice</p> <p>Safeguards through committee structure as discussed in bilateral discussions with stakeholders</p>	<p>Existing organisational structures especially for PE and RE companies can remain unchanged.</p>	<p>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.</p>	<p>Based on the discussions during bilateral discussions with stakeholders and as already mentioned above the current practise for PE and RE managers is the assignment of committees.</p>
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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
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<p>Option 1 presented in consultation paper and adopted by ESMA in the advice in relation to liquidity management policies and procedures including a principles based approach in relation to the use of tools and arrangements :</p> <p>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</p>	<p>Diminishes herding behaviour.</p> <p>Diminishes revolving risk.</p> <p>Diminishes counterparty risk.</p> <p>Provides clarity for investors whilst providing AIFM's with flexibility to address changing market circumstances.</p> <p>Reduces the risk that tools and arrangements are utilised in inappropriate circumstances.</p>	<p>Increase in operational and funding costs.</p>	<p>Survey of firms, consultation responses.</p>
<p>Option 2 considered by ESMA when developing the advice in relation to liquidity management policies and procedures including a disclosure based approach in relation to the use of tools and arrangements :</p> <p>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</p>	<p>Diminishes herding behaviour.</p> <p>Diminishes revolving risk.</p> <p>Diminishes counterparty risk.</p> <p>Provides investors with knowledge of tools and arrangements that may be utilised.</p>	<p>Increase in operational and funding costs.</p> <p>Risk of different interpretations by AIFMs and provided limited clarity to investors.</p>	<p>Survey of firms, consultation responses.</p>

Option 3 considered by ESMA when developing the advice 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

<p>Diminishes herding behaviour.</p> <p>Diminishes revolving risk.</p> <p>Diminishes counterparty risk.</p> <p>Provides a higher level of certainty for investors as to the use of tools and arrangements to manage liquidity.</p>	<p>Increase in operational and funding costs.</p> <p>May limit AIFMs ability to respond to unforeseen circumstances if requirements are too prescriptive, therefore not acting in the best interests of investors.</p>	<p>Survey of firms, consultation responses.</p>
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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
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<p>Option 1 presented in consultation paper and adopted by ESMA in the advice in relation to the alignment of investment strategy, liquidity profile and redemption policy:</p> <p>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.</p>	<p>Diminishes liquidity risk and increases investor protection.</p> <p>Conveys importance of investments being selected that fit redemption policy.</p> <p>Enforces an obligation on AIFMs to act in a manner consistent with the fair treatment of investors.</p>	<p>Limits AIFM's investment options.</p> <p>Allows AIFMs discretion in the use of tools and arrangements to defer or restrict redemptions.</p>	<p>Survey of firms, consultation responses.</p>
<p>Option 2 considered by ESMA when developing the advice in relation to the alignment of investment strategy, liquidity profile and redemption policy:</p> <p>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.</p>	<p>Diminishes liquidity risk and increases investor protection.</p> <p>Highlights the importance of being able to meet redemption requests as they fall due without the need for fire sales.</p> <p>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.</p>	<p>Limits AIFM's investment options.</p>	<p>Survey of firms, consultation responses.</p>

<p>Option 3 considered by ESMA when developing the advice in relation to the alignment of investment strategy, liquidity profile and redemption policy:</p> <p>Extension of option 2 above to link to the liquidity management policies and procedures approach in relation to the use of tools and arrangements:</p>	<p>Diminishes liquidity risk and increases investor protection.</p> <p>Highlights the importance of being able to meet redemption requests as they fall due without the need for fire sales.</p> <p>Sets parameters for the use of tools and arrangements which should be consistent with the fair treatment of investors.</p> <p>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.</p>	<p>Limits AIFM's investment options.</p>	<p>Survey of firms, consultation responses.</p>
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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. Box 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
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Option	Benefits	Costs	Evidence
<p>Option 1 (retained in the final advice)</p> <p>Taking into account relevant provisions of CRD including guidelines to Article 122a CRD as well as Solvency II and respective advice given</p>	<p>Level playing field with other financial institutions such as banks and insurance undertakings in order to achieve systemic stabilisation of securitisation industry.</p> <p>Strong obligation on AIFM to conduct thorough due diligence prior to investment therefore achieving indirect regulation of parties to the respective securitisation transaction.</p> <p>At the same time, overall systemic stabilisation of securitisation industry and due diligence prior to investment result in better investor protection.</p>	<p>Relevant costs due to specific complexity of securitised products will arise prior to every investment.</p> <p>Ongoing product innovations may require constant adaption of due diligence processes.</p>	<p>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.</p>
<p>Option 2</p> <p>Developing own regime for AIFM</p>	<p>‘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.).</p>	<p>Risk of regulatory failure and arbitrage.</p> <p>Risk for investor protection and systemic stability.</p>	

7.2. Box 38-39-40-41 Qualitative requirements to be met by an AIFM

<p>Option 1 (retained in the final advice)</p> <p>Implementation of specific organisational requirements</p>	<p>Long term benefits for AIFM/AIF and investors due to proper assessment and on-going monitoring of specific risks related to securitised products.</p> <p>Implementation of adequate requirements for risk and liquidity management, monitoring procedures, stress testing and formal policies, procedures and reporting.</p>	<p>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).</p>	<p>Financial crisis showed that risks of securitised products were underestimated.</p>
<p>Option 2</p> <p>Treating securitisations like any other investment in transferable securities with respect to risk, liquidity management etc.</p>	<p>Short term benefits solely for AIFM/AIF due to less operational costs.</p>	<p>High risk for investors due to complexity of securitised products.</p>	

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
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<p>Option 1 (retained in the final advice)</p> <p>Adapting the MiFID/UCITS L2 directive requirements</p>	<p>Consistency with existing regulation.</p> <p>Also, overall it might be beneficial to implement a level playing field with other investment fund managers.</p>	<p>Low incremental costs since qualified fund managers already comply with organisational principles and UCITS managers have already to comply with respective rules.</p>	
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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
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Option	Benefits	Costs	Evidence
Option 1 (retained in the final advice) General criteria	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
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<p>Option 1 (retained in the final advice)</p> <p>NAV calculation at each subscription or redemption but at least once a year</p>	<p>Ensuring a market standard for valuation points in time which are relevant for the investors.</p> <p>Level playing field with other investment funds.</p>	<p>Costs of implementation and ongoing calculation.</p>	<p>Similar rules for UCITS have proven beneficial.</p>
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9.3. Box 61 Professional guarantees of external valuer

Risks addressed / Policy objective

- Investor Protection

- Rules apply to all types of AIFM.

Options	Benefits	Costs	Evidence
Option 1 (retained in the final advice)	<p>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.</p> <p>Standardized formal criteria for supervisors, that the valuation task is performed by a competent valuer.</p>	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
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<p>Option 1 (retained in the final advice)</p> <p>General rules for all assets</p>	<p>Minimum standard level for valuation procedures for all AIFM is beneficial to investors (enhances investor confidence).</p>	<p>Low incremental costs since qualified fund managers already comply with valuation rules.</p>	<p>Similar rules for UCITS have proven beneficial to investors.</p>
<p>Option 2</p> <p>Specific rules for different assets other than financial instruments</p>	<p>Higher frequency of valuation for some types of instruments could be beneficial to investors.</p>	<p>Risk of unsuitable design of regulation due to diversity of assets.</p>	

10. Delegation

Risks addressed / Policy objective

- Investor Protection
- Market Integrity

Scope Issues

10.1. Box 63 and 64 General principles

Option	Benefits	Costs	Evidence
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Option	Benefits	Costs	Evidence
<p>Option 1 (retained in the final advice)</p> <p>Adapting the MiFID L2 directive requirements</p>	<p>Consistency with existing regulation.</p> <p>Also, overall it might be beneficial to implement a level playing field with other investment fund managers and other market players.</p>	<p>One-off costs for implementing delegation principles and running costs for management of delegation risks.</p>	<p>Grown importance of delegation in the financial sector.</p>

10.2. Box 65 Objective reasons

Options	Benefits	Costs	Evidence
<p>Option 1</p> <p>General principle for justification of delegation</p>	<p>Consistency with existing UCITS provisions.</p> <p>More flexibility for AIFM.</p>	<p>Incremental costs of self-assessment.</p>	
<p>Option 2</p> <p>List of examples for objective reasons.</p>	<p>More detailed guidance for self-assessment of AIFM regarding objective reasons.</p>	<p>Incremental costs of self-assessment.</p>	

<p>Option 3 (retained in the final advice)</p> <p>Combination of a general principle for justification of delegation and list of examples for objective reasons.</p>	<p>Providing both flexibility for AIFM and guidance for self-assessment of AIFM regarding objective reasons.</p>	<p>Incremental costs of self-assessment.</p>	<p>General support from respondents to the consultation</p>
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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
<p>Option 1 (retained in the final advice)</p> <p>Definition of general circumstances</p>	<p>More detailed guidance for self-assessment of AIFM regarding delegates.</p> <p>Better supervision of selection of delegates as a precondition for the proper functioning of AIFM.</p>	<p>One-off costs for implementing selection criteria and running costs for monitoring of compliance.</p>	<p>Grown importance of delegation in the financial sector. Feedback from the consultation highlighted some elements which were overly restrictive and have been removed in the final advice.</p>

10.4. Box 68 Eligible institutions authorised or registered for asset management and subject to supervision

Risks addressed / Policy objective

- Investor Protection

Option	Benefits	Costs	Evidence
<p>Option 1</p> <p>General criteria for eligible institutions.</p>	<p>More flexibility, judgement of each case on its own merits.</p> <p>No differentiation between delegates in EU and in third countries.</p>	<p>Higher costs for evaluation of eligibility.</p>	
<p>Option 2</p> <p>Specific categories for eligible institutions.</p>	<p>Where possible, more detailed guidance for AIFM with the benefit of less uncertainty about eligible delegates.</p>	<p>Risk of too restricted choice of delegates and therefore strong regulatory influence on business models.</p>	<p>No suitable categories in third countries due to diversity of regulation and supervisory standards.</p>
<p>Option 3 (retained in the final advice)</p> <p>Mixed approach: specific categories for EU delegates and general criteria for third countries</p> <p>.</p>	<p>Optimisation of option 1 and 2.</p>	<p>One-off costs for implementing selection criteria and running costs for monitoring of compliance.</p>	<p>Grown importance of delegation in the financial sector.</p>

10.5. Box 69 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 1 (retained in the final advice)	<p>Consistency with MiFID regulation.</p> <p>Prevents AIFM from circumventing AIFMD by outsourcing to delegates in third countries where home supervisor has no powers to access premises or data.</p>	Incremental costs for adapting outsourcing agreements.	Already market standard for investment firms.

10.6. Box 70 Criteria for identification and management of conflicts of interests

Option	Benefits	Costs	Evidence
<p>Option 1 (retained in the final advice)</p> <p>General criteria</p>	<p>Guidance for AIFM and regulators by specific examples.</p> <p>More transparency and investor confidence.</p> <p>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.</p>	<p>Costs for implementing functional and hierarchical separation.</p> <p>Running costs for monitoring of compliance.</p>	Market standard for delegates which are (MiFID) investment firms.



10.7. Box 74 Letter-box entity

Risks addressed / Policy objective

- Investor Protection
- Market Integrity

Scope Issues

General principle applies to all AIFM.

Option	Benefits	Costs	Evidence
<p>Option 1 (retained in the final advice)</p> <p>Conditions for assessment of letter-box entity .</p>	<p>Guidance for AIFM and regulators.</p> <p>More transparency and investor confidence.</p>	<p>Running costs for monitoring of compliance.</p>	



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 75 Determining the particulars that need to be included in the standard agreement

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.

Policy options	Benefits	Costs	Evidence
Option 1 Reusing the requirements of the UCITS directive which defines the minimum elements of the contract	Consistency with existing regulation	Risk of missing some issues specific to AIF	
Option 2 retained in the final advice Adapting the UCITS directive requirements and adding specific provisions applicable to AIF depositaries.	Consistency with existing regulation Regulation tailored to AIF specificities	Slight increase in costs	General support from respondents to the consultation
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 harmonised 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 harmonisation 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
Option 1 Establishing a model agreement	Higher degree of harmonisation 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 retained in the final advice 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 harmonisation	Broad support from respondents to the consultation

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 pursuant to paragraph 7 – cash monitoring

a)

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:



to specify the conditions for performing the depositary functions pursuant to paragraphs 7

i. 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 [...]

ii. 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 77

Policy options	Benefits	Costs	Evidence
<p>Option 1</p> <p>The depositary:</p> <ul style="list-style-type: none"> - 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. 	<p>Appropriate control of the operational risk</p> <p>Appropriate control and processes to ensure the depositary has all the relevant information.</p>	<p>Incremental cost to depositaries, AIFM and third parties for implementing adequate procedures (no additional cost in some Member States)</p>	
<p>Option 2 retained in the final advice</p> <p>The depositary:</p> <ul style="list-style-type: none"> - is informed upon its appointment of all existing cash account with third parties; - is informed at the opening of a cash account with a third party; and - receives all relevant information in order to appropriately monitor all 	<p>Appropriate control of the operational risk</p> <p>Appropriate control and processes to ensure the depositary has all the relevant information.</p>	<p>Incremental cost to depositaries, AIFM and third parties for implementing adequate procedures (no additional cost in some Member States)</p>	

 the AIF's cash flows.			
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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 77

Policy options	Benefits	Costs	Evidence
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 retained in the final advice Ex-post monitoring	High degree of flexibility allowing an efficient investment process. Lower implementing costs for depositaries. More in line with existing market practice	Lack of ex ante control over cash flows.	Broad support from respondents to the consultation

ESMA consulted 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.

Policy options	Benefits	Costs	Evidence
<p>Option 1</p> <p>Ensure the cash received upon the subscription of shares or units of an AIF is booked in an account opened at the depositary.</p>	<p>Better information of the depositary at all time.</p> <p>Stronger oversight by the depositary.</p>	<p>Limitation of the distribution channel.</p> <p>Restrictive interpretation of the AIFMD text.</p>	
<p>Option 2 retained in the final advice</p> <ul style="list-style-type: none"> - 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. 	<p>No need to modify the distribution channels.</p>		
<p>Option 3</p>	<p>Insurance of proper booking of the subscrip-</p>	<p>Additional costs.</p>	

<p>Additional requirement: Ensure that a reconciliation between the subscription commitment and the subscription proceeds is performed</p>	<p>tion proceed.</p>		
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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

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 should have a stronger impact in terms of reducing systemic risk. 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 harmonisation between jurisdictions.

Not providing any additional requirements beyond 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. This option has been retained in the final advice.

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 in which the AIF opens an account because of its investment strategy.

12.2. Depository functions pursuant to paragraph 8 – safe keeping duties

b)

12.2.1. Objectives and underlying problems

In order to reduce the default risk and increase investor protection and confidence, the AIFMD requires that the assets of the AIF be entrusted to the depository for safe-keeping. Safe-keeping can take the form of custody or record-keeping. The AIFMD text provides a high-level definition of assets to be held in custody and the associated custody regime, while 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 depository's custody duties and the conditions applicable to the depository 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 depository when exercising its safekeeping duties over such 'other assets'
- iii. to advise on the conditions upon which the depository shall verify the ownership and the information, documents and evidence upon which a depository may rely to perform such a task
- 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



c) Means for determining the type of financial instruments that should be held in custody

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. The AIFMD cross-refers to the definition used in MiFID, which provided a harmonised 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 (exhaustive 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 an exhaustive 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. In the final advice, the definition was expanded in order to cover transferable securities embedding derivatives.

d) Definition of financial instruments to be held in custody (Box 79)

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 harmonised 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 79 Definition of financial instruments to be held in custody

Policy options	Benefits	Costs	Evidence
<p>Option 1</p> <p>Financial instruments which are settled through a CSD</p>	<p>Clarity</p>	<p>Notion of CSD not harmonised across Member States</p> <p>Large number of countries without a CSD</p>	
<p>Option 2</p> <p>Financial instruments that are settled through a settlement system or system deemed equivalent</p>	<p>Rely on a definition harmonised at the European level</p> <p>Reflects current market practice</p>	<p>Difficulty to define a system deemed equivalent</p>	
<p>Option 3 retained in the final advice</p> <p>Financial instruments belonging to the fund and registered directly or indirectly in the name of the depositary</p>	<p>Clear link between the depositary’s liability and the ability to instruct a transfer</p> <p>Greater consistency with Level 1 Directive</p>		

A comparison of the costs and benefits of the different options only allowed option 1 to be ruled out. ESMA therefore consulted on both options 2 and 3.

- e) Means for determining conditions applicable to custody duties



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 and was therefore retained in the final advice.

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, potentially complemented by a non-exhaustive list in the explanatory text.

Defining the ‘other assets’ in the same positive manner as for the assets to be held in custody would provide clarity. Nevertheless, there is a substantial risk that some assets escape from either one or the other regime. Such loopholes would be very harmful for the concrete application of the Directive.

An ***a contrario* approach**, which would involve considering as ‘other assets’ the assets that are not included in the scope of the depositary’s custody duties, provides clarity as well as 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’, and has as such been retained in the final advice.



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.

Taking into account the costs and benefits of the different options, ESMA decided to base its approach in the final advice on defining general principles.

c) Regime for 'record keeping' of 'other assets' (Box 81)

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
Option 1 retained in the final advice Strict oversight of all transactions	Flexibility to adapt the record keeping to different types of assets.	Reliance on third party data	Broad support from respondents to the consultation
Option 2 Mirroring all transactions	All information related to the AIF's portfolio kept on a single record at the depository.	Implementing costs of changing the technology system.	

An initial comparison of the costs and benefits of the different options established that further input was needed from market participants. Taking into account the feedback to the consultation, ESMA decided to retain option 1 in the final advice.

12.2.2.3. Determining the conditions for verifying the ownership of assets

a) Form of the requirement

ESMA has to propose which form is the most appropriate for the requirement stating that the depository 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 depository 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 depository. 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 depository even though further action would be necessary.

Establishing **principles** based on which it will be possible for the depository 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 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 organisation 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 and, on the other hand, the increased fees potentially requested by the depositary and the reduced scope 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 costs. The current market practice would be maintained. However, it would not improve the situation, particularly as 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). As ESMA chose option 1 in Box 78 (now Box 79) of the advice with respect to financial instruments to be held in custody, option 2 was considered the most appropriate in the context of nominee accounts.

Boxes 79 and 81 - Regime for nominee accounts

Policy options	Benefits	Costs	Evidence
Option 1 Custody duties	Clarification of the market. Flexibility for the depositary to choose the regime most advantageous.		
Option 2 retained in the final advice 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 Financial Collateral Directive provides a clear definition of the ‘title transfer financial collateral arrangements’⁵², there is no harmonisation among the Member States regarding the right of ownership. This partial degree of harmonisation 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 depository’s book are outside the scope of custody is an approach which was put forward by some market participants as more consistent with market practice.

Not providing any distinction would effectively mean 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.

Criteria to distinguish the different situations (temporary lending, repurchase arrangements, re-use, and collateral)

Box 79

⁵² 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

Policy options	Benefits	Costs	Evidence
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 retained in the final advice Distinction on two criteria: - transfer of ownership - existence in the depositary's books	Custody duties only if control over the assets.		Seen by many respondents to consultation as reasonable compromise between protection of AIF assets and recognition of current market practice.
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.	

ESMA consulted on the three options identified above in order 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. Depository functions pursuant to paragraph 9 – oversight duties

f)

12.3.1. Objectives and underlying problems

In order to reduce micro-prudential risk and improve investor protection, the depository 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 depository 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 depository 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 harmonisation as AIFs will be ‘passport’ across Europe and AIFMs will be granted a ‘management company’ passport by which they will be entitled to set up and to manage AIFs in other Member States. ESMA has to choose the proper form to present the elements specifying the depository oversight duties. Four options were considered by ESMA: i) defining principles; ii) a general principle based on a commonly shared assumption that the depository 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 harmonisation would not be achieved.

A general principle starting from a **common assumption** that the depository 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 harmonisation 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 depository should carry out to fulfil its oversight duties provides a high degree of harmonisation although this harmonisation 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 harmonisation 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 harmonised tasks have to be accounted for.



Establishing **an exhaustive list** provides the highest level of harmonisation 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.

An initial comparison of the costs and benefits of the different options suggested that a clarification of each duty using a principles-based approach was the best way to ensure the right balance between flexibility and the objective of proper and comprehensive harmonisation. This approach was confirmed in the final advice.

b) Content of the advice regarding oversight duties (Boxes 83 to 88)

In its advice, ESMA tried to provide precisions on the five oversight duties included in AIFMD and based on the UCITS Directive. This initiative was motivated by the need for harmonisation of regulation across the EU. Moreover, as the question is highly related to the requirements imposed by the UCITS directive on the same topic, ESMA 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 and where this has been agreed with the AIFM.

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

g)

12.4.1. Objectives and underlying problems

In order to reduce micro-prudential risk and improve investor protection, the AIFMD 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 89)

ESMA has to develop requirements on 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 principles-based approach; ii) a principles-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 principles-based approach provides stronger investor protection since the responsibility lies with the depositary and in case the procedures for due diligence have not been applied in line with



principles established in legislation, the liability of the depositary 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 principles-based approach by specifying the conditions applicable to the sub-custodian provides for additional diligence and, as a consequence, a higher level of investor protection. Nevertheless, a certain level of legal uncertainty remains. The increased 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 harmonisation 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 initial assessment of the costs and benefits of the different options indicated that a principles-based approach, including criteria to be met by the sub-custodian, was the most suitable approach to imposing obligations on 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 ongoing 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 to which it is subject. However, it would remain useful to require the depositary to have a documented process for the due diligence so as to facilitate the assessment by the competent authorities. In the same perspective, designing a contingency plan appears to be best market practice that should be encouraged. 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 harmonised 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 harmonisation 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
Option 1 Establishing a model agreement	Higher degree of harmonisation.	Lack of flexibility. Impossible to adapt to all types of AIF.	
Option 2 retained in the final advice Not providing a model agreement	Preservation of the adaptability to a wide range of business models and legal environments.	Lower degree of harmonisation.	Broad support from respondents to consultation

An initial comparison of the costs and benefits of the different options indicated that it was preferable not to establish a comprehensive template for the due diligence and that it would be more appropriate to develop some detailed criteria (based on current best practices in the market) that the depositary would be required to apply. This was the approach retained in the final advice.

12.5. The segregation obligation, Art. 21

h)

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 above, 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 90)

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 to adapt the requirements set out in that Directive in order to tailored them to specificities of AIFs.

Article 16 of Directive 2006/73/EC (MiFID) provides a strong basis to design the segregation requirements imposed by the AIFMD. Taking inspiration from MiFID ensures 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 appropriate. This option leaves 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, Art. 21

i)

12.6.1. Objectives and underlying problems

A balance has to be struck between ensuring a high level of investor protection while at the same time not putting the entire responsibility on the depositary, which could increase the incentive for regulatory arbitrage or lead in some circumstances to systemic risk. To do so, the AIFMD 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 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.

12.6.2. Options, impact and comparison

12.6.2.1. Definition of the 'loss of financial instruments'

a) Form of the definition (Box 91)

ESMA has to decide which approach to take when providing 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 have no impact on the costs and benefits involved. It would even lead to more uncertainty.

Having criteria on the basis of 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 established, transparency is enhanced. However, such a degree of information implies some implementation costs for markets participants 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 determine whether an asset is lost. Meanwhile, the advice sets out 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 91)

ESMA considered possible options on the process to be followed in order 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 harmonisation 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
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 retained in the final advice Not providing any additional requirement	More flexibility	Risk of not achieving the harmonisation objective	General support from market participants

An initial comparison of the costs and benefits of the different options suggested that not providing additional requirements would provide a suitable degree of flexibility while leaving the door open to a conciliation procedure when deemed appropriate by the parties involved. This approach has been retained in the final advice.



12.6.2.2. Distinction between permanently 'lost' and temporarily 'unavailable' (Box 91)

ESMA's input is requested on distinguishing 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 longer 'temporarily unavailable' would provide clarity and would ensure a high level of harmonisation. 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 authorised. 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 harmonisation.

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 harmonised 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 harmonisation.	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 retained in the final advice Relying on the notion of permanence	Higher level of clarity.	Restrictive approach.	Broad support by respondents to the consultation

An initial comparison of the costs and benefits of the different options suggested that was 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

12.7.2.1. Definition of ‘external event beyond the depositary’s reasonable control, the consequences of which were unavoidable despite all reasonable efforts to the contrary’ (Box 92)

ESMA was requested 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 would have been 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 to be discharged from its liability to return financial instruments or the corresponding amount.

ESMA 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 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 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 most negative scenario, the depositary would be liable to return the financial instruments entrusted to a sub-custodian. One market participant 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
<p>Option 1 retained in the final advice</p> <p>Definition of external event beyond reasonable control, the consequences of which were unavoidable despite all reasonable efforts to the contrary</p>	<p>High degree of investor protection.</p> <p>Insurance of a strong level of due diligence.</p>	<p>High capital cost for the depositaries.</p> <p>Increase in systemic risk.</p> <p>Moral hazard.</p>	<p>Feedback suggested general increase in costs. Specific estimates included an increase of 4-5 times or the imposition of capital charges of 8% of the assets held in custody.</p>

An initial comparison of the costs and benefits indicated that input on this question from stakeholders would be very useful. Taking into account the feedback received as well as the proper interpretation of the Level 1 Directive, ESMA retained its general approach (with some modifications) in the final advice.

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 would have been 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 would have been unavoidable despite all reasonable effort to the contrary*’. ESMA stressed that this list was non-exhaustive and had 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

The AIFMD 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. In order to help achieve clarity in the approach to contractual discharges, 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 93)

ESMA was requested to provide 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 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, ESMA was aware that taking an overly restrictive approach to conditions for the objective reason to contract a discharge would effectively 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
<p>Option 1 retained in the final advice</p> <p>Written agreement dealing with legal constraints and weighting of associated costs / risks by the AIFM</p>	<p>Investor's best interest taken into account.</p>	<p>Increase in systemic risk.</p> <p>Restrictive approach.</p>	<p>Supported by some investment management and institutional investor representatives.</p>
<p>Option 2</p> <p>No further requirement (Contractual agreement establishes an objective reason)</p>	<p>Flexibility.</p> <p>Freedom of contract not affected.</p>	<p>No additional level of investor protection.</p> <p>Investor's best interest not taken into account.</p>	<p>Supported by many depositaries and some investment management stakeholders.</p>

An initial comparison of the costs and benefits of the two options suggested that both should be subject to consultation. In the final advice, ESMA decided to adopt an amended version of option 1. The amendments were designed to balance the more flexible approach that ESMA proposes for the application of the criteria.

12.8.2.2. Indicative list of scenarios

ESMA had to consider whether or not to provide 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
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Option 1 adopted by ESMA in the advice (combination of Options 3 and 4)

Setting out 3 methods for the calculation of leverage (Gross Method, Commitment Method and Advanced method)

Harmonisation: provide a harmonised approach to the calculation across the EU.

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
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:

AIFM will 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.

<p>Option 2 considered by ESMA when developing the advice</p> <p>Setting out one method for the calculation of Leverage</p>	<p>Harmonisation: Would provide a highly harmonised approach to the calculation across the EU and result in easy aggregation by ESMA</p>	<p>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.</p> <p>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.</p> <p>Macro-prudential risks: If all AIFM are managing leverage using the same method then an external shock could cause pro-cyclical effects if all AIFM acted in the same way.</p>	<p>Targeted industry engagement and consultation.</p>
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Option 3 considered by ESMA when developing in the advice

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.

<p>Option 4 considered by ESMA when developing the advice</p> <p>Permitting a more flexible approach to the netting of positions and the general calculation of exposure</p>	<p>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).</p> <p>Administrative Burden: Specific tailoring for the heterogeneous population of AIF.</p>	<p>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.</p> <p>Harmonisation: Reduced harmonisation of applicable, however if one of the methods is highly harmonised then this cost is reduced.</p>	<p>Targeted industry engagement and consultation.</p>
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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
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<p>Option 1 presented in the consultation paper and adopted by ESMA in the advice.</p> <p>The setting out of illustrative circumstances and criteria that should guide the assessment taken by competent authorities</p>	<p>It would not be possible to set out a full list of factors that competent authorities 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.</p>	<p>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.</p>	<p>Consultation</p>
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Option 2 considered by ESMA when developing the advice

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

14.1. 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
<p>Overview/summary: Annual Report</p>	<p>Mitigate information asymmetry, increase market efficiency through a common approach to protecting investors in AIFM managed funds.</p>	<p>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).</p>	<p>Level of one off costs to change format of financial statements and incremental compliance costs for AIFM (additional disclosure, calculation, preparation and audit costs).</p> <p>Feedback on the concerns of the industry with regard to possible incompatibility with local GAAP or rules of the AIF.</p>

Option	Benefits	Costs	Evidence
		<p>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.</p>	
<p>Option 1</p> <p>Option presented in consultation paper and adopted by ESMA in the advice in relation to Annual report:</p> <p>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.</p>	<p>Mitigate information asymmetry, increase market efficiency through a common approach to protecting investors in AIFM managed funds;</p> <p>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.</p>	<p>May require one off costs to change format of financial statements including reclassification of comparatives where presented and incremental compliance costs for AIFM (additional disclosure, calculation, preparation and audit costs).</p>	<p>Level of one off costs to change format of financial statements and incremental compliance costs for AIFM (additional disclosure, calculation, preparation and audit costs).</p> <p>Feedback on the concerns of the industry with regard to possible incompatibility with local GAAP or rules of the fund</p>

<p>Option 2</p> <p>Option considered by ESMA when developing the advice</p> <p>Specification of minimum content with the application of relevant accounting standards and rules.</p>	<p>Mitigate information asymmetry, increase market efficiency through a common approach to protecting investors in AIFM-managed funds;</p>	<p>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).</p> <p>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</p>	<p>Level of one off costs to change format of financial statements and incremental compliance costs for AIFM (additional disclosure, calculation, preparation and audit costs).</p> <p>Feedback on the concerns of the industry with regard to possible incompatibility with local GAAP or rules of the fund</p>
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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
<p>Option 1:</p> <p>Option presented in consultation paper and adopted by ESMA in the Advice 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.</p>	<p>Enables investors to assess how remuneration paid relates to overall fund performance and how it supports effective risk management;</p> <p>Enables comparison across funds and assessment of risk;</p> <p>Benefits will depend on whether information is used and understood, on the quality of information provided and its comparability.</p>	<p>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, increased preparation costs due to increased level of disclosure and increased audit costs);</p> <p>Potential additional costs in relation to:</p> <ul style="list-style-type: none"> ▪ Changes in systems and controls ▪ Changes in data collection and reporting ▪ Record keeping <p>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.</p> <p>Could result in breach of confidentiality or disclosure of proprietary information.</p>	<p>Feedback from the industry on the ability to extract this information in an efficient and effective manner.</p> <p>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.</p>

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.

Disclosure provisions will apply to all AIFM but need to be scalable.

Option	Benefits	Costs	Evidence
<p>Overview/Summary:</p> <p>Disclosure to investors</p>	<p>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.</p> <p>Mitigate information asymmetry, increase market efficiency through a common approach to protecting investors in AIFM-managed funds;</p> <p>Greater public accountability of private equity transaction (debt levels incurred).</p> <p>Ensuring a level playing field for AIFMs in the single market and developing a single market in AIF with minimum common disclosure standards;</p> <p>Reduce potential for weakness in investor disclosures as barrier to effective due diligence;</p>	<p>Set up and incremental compliance costs for AIFM (recalculation, publication costs).</p> <p>Possible calibration failures of proportionality concerns and resulting competitive issues for certain players.</p>	<p>Set up and incremental compliance costs for AIFM (recalculation, publication costs).</p> <p>Feedback on the concerns of the industry with regard to the calibration of measures.</p>

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	<p>Enables regulators to get a view on the build-up of illiquidity issues in the market;</p> <p>Warning signs to investors in AIF concerned who may make alternative arrangements when they need liquidity;</p>	<p>Set up (calculation for percentage of assets subject to special arrangements method for leverage) and incremental compliance costs for firms (recalculation, publication costs)</p>	<p>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</p>
<p>Option presented in consultation paper and adopted by ESMA in the advice in relation to disclosure of percentage of assets subject to special arrangements⁵³: 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.</p>	<p>Limits risk of contagion of liquidity issues as underlying investors can take measures to manage their liquidity;</p> <p>Reduces investor frustration and reputational risk for the AIFM through clear communication;</p>	<p>Low incremental costs as disclosures are part of periodic reporting costs (set-up and maintenance) at the regulators for receiving and processing the information;</p>	<p>Cost of compilation and disclosure of information in periodic reporting.</p> <p>Input on the definition of "special arrangements".</p>

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

⁵³ 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.

All AIFM for each EU AIF it manages and for each of the AIF it markets in the EU

Option	Benefits	Costs	Evidence
<p>Overview/summary</p>	<p>Proper monitoring of macro-prudential risks through enhanced transparency of AIFM activity; Common approach to protect professional investors in AIFM managed funds;</p>	<p>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;</p>	<p>Cost of compilation and disclosure of information on an ad hoc basis.</p>
<p>Option presented in consultation paper and adopted by ESMA in the Advice in relation to disclosure of new arrangements for managing liquidity:</p> <p>Disclosure triggered by a material change to the liquidity management systems and procedures</p> <p>Immediate notification required where AIFMs activate gates, side pockets or similar special arrangements or in the event of a decision to suspend redemptions</p> <p>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.</p>	<p>Common approach for all AIFM mitigates information uncertainty and information asymmetry for investors.</p>	<p>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).</p>	<p>Evidence of instances that are considered material changes by the industry under the current definition and resulting disclosure costs;</p> <p>Evidence of liquidity</p> <p>Arrangements that would likely be taken by the industry;</p>



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
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<p>Overview/summary:</p>	<p>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;</p>	<p>Compliance costs at AIFMs and regulators</p>	<p>Evidence of initial and incremental compliance costs in particular with regard to changes in strategy within portfolios (likely frequency of necessary updates).</p>
<p>Option 1 presented in consultation paper and adopted by ESMA in the advice in relation to disclosure of 1) the current risk profile of the AIF; and 2) the risk management systems employed to manage these risks with the incorporation of some elements of the option on the disclosure of current risk profile:</p> <p>1) Disclosure of current risk profile (Discretion for manager to determine appropriate disclosures):</p> <ul style="list-style-type: none"> ▪ 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. <p>2) Disclosure of the risk management systems employed to manage these risks:</p> <ul style="list-style-type: none"> ▪ 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. 	<p>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;</p>	<p>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;</p>	<p>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.</p>

<p>Option 2 considered by ESMA when developing the advice</p> <p>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:</p> <p>1) Disclosure of current risk profile (Prescriptive requirements):</p> <ul style="list-style-type: none"> ▪ Disclosure frequency in relation to risk profile to align with the AIF's periodic reporting to investors. ▪ Disclosure to contain all the following: <ol style="list-style-type: none"> 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. <p>2) Disclosure of the risk management systems employed to manage these risks: (same as option 1)</p>	<p>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;</p>	<p>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;</p> <p>If measures are too prescriptive or specific may lead to difficulties in calibrating across different types of AIF</p>	<p>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.</p>
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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
<p>Overview/summary:</p>	<p>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.</p> <p>Ability to focus action on AIFM of systemic relevance.</p>	<p>Calculation costs.</p> <p>Disclosure costs.</p>	<p>Evidence of current (if any) disclosure practices (frequency, detail of disclosure, current calculation methods).</p> <p>Evidence of preferred disclosure medium/media.</p>

<p>Option presented in consultation paper and adopted by ESMA in the advice in relation to disclosure of changes to the maximum leverage level and related rights or guarantees:</p> <p>Disclosure triggered by a material change Disclosure to contain the following information as appropriate:</p> <ul style="list-style-type: none"> ▪ 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 	<p>Level playing field for AIFM and AIFs.</p> <p>Less uncertainty as to reasons for disclosure.</p> <p>Mitigate information asymmetry for investors.</p>	<p>Possible uncertainty as to the interpretation of "material changes" and hence unequal trigger moments.</p> <p>Uncertainty by investors as to what constitutes material changes and as to whether there is leeway in interpretation at AIFMs.</p> <p>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).</p>	<p>Industry input as to the definition of "material changes".</p> <p>Disclosure costs - input as to the preferences with regard to disclosure medium.</p> <p>Input on the possible format of disclosures.</p>
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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;

<p>Option presented in consultation paper and adopted by ESMA in the advice 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</p> <p>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.</p>	<p>Harmonised disclosure of leverage levels and furthering of the single market for AIF as leverage levels will be comparable across member states;</p> <p>Isolation of leverage as a driver of return within a peer group of AIFs - more granularity in due diligence for investors;</p> <p>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);</p> <p>Better view on the sustainability of leveraged transactions;</p> <p>Regulators receive information to identify players of systemic relevance</p>	<p>Costs for AIFM should be low as disclosures are part of initial fund documentation or periodic reporting;</p>	<p>Evidence of current and preferred/possible disclosure practices prior to common regulation (frequency, detail of disclosure, current calculation methods)</p>
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14.9. Box 110: 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.

Option	Benefits	Costs	Evidence
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Option 1 adopted by ESMA in the advice

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:

1. AIFM to report to competent authorities at a frequency varying according to their assets under management and the size of each they manage.
- (d) AIFM managing portfolios of AIFs whose assets under management calculated according to Box 1 are below the thresholds calculated in Article 3(2)(a) and (b) shall report the information in Paragraph 1 on an annual basis;
- (e) AIFM managing portfolios of AIFs whose assets under management calculated according to Box 1 are above the thresholds calculated in Article 3(2)(a) and (b) but below EUR1.5bn shall report the information in Paragraph 1 and Paragraph 3 on a semi-annual basis for each of the EU AIF it manages and for each of the AIF it markets in the Union; and
- (f) AIFM managing portfolios of AIFs whose assets under management as calculated to Box 1 are above EUR1.5bn shall report the information in Paragraph 1 and Paragraph 3 on a quarterly basis for each of the EU AIF it manages and for each of the AIF it markets in the Union;

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.

The frequency reporting is not identical for all AIFMs and AIFs. It depends on the number of assets under management at the level of the AIFM, the size of the AIF or the nature of the investment.

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).

Industry / Regulator level

- 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

<p>2.* AIFM subject to the requirements in point (b) above shall for each AIF whose assets under management, including any assets acquired through the use of leverage, is greater than EUR500mn report the information in Paragraph 1 and in Paragraph 3 on a quarterly basis in respect of that AIF.</p> <p>3. AIFM shall, in respect of each unlevered AIF under its management which in accordance with its core investment policy invest in non-listed companies and issuers in order to acquire control, report the information in Paragraph 1 and provide the information in Paragraph 3 on an annual basis.</p> <p>4. As an exception to paragraph 4, the competent authority of the home Member State of the AIFM may deem it appropriate to require all or part of the information to be reported on a more frequent basis.</p> <p>5. 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.</p>			
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Option 2 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).

Industry / Regulator level

- 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 3 considered by ESMA when developing the advice

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 assets under management

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).

Industry / Regulator level

- 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 bilateral discussions

Study on costs

**Option 4 considered by ESMA when developing the advice:
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).

Industry / Regulator level

- 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 bilateral discussions

Study on costs

14.10. Box 111 Leverage Reporting

Reporting obligations to competent authorities when leverage is considered to be employed on a substantial basis

Option	Benefits	Costs	Evidence
<p>Option 1 retained by ESMA in the Advice</p> <p>AIFM's self-assessment based on qualitative criteria</p>	<p>Option takes into account the need to avoid excessive burden for competent authorities (art. 24.6 L1).</p> <p>Availability of proper information for the regulators in order to identify sources of systemic risks.</p> <p>Option permits the differentiation between diverse kind of AIFs limiting, at the same time, the discretionary power of the AIFM.</p>	<p>Subjectivity for AIFM in the verification of the "threshold".</p> <p>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.</p> <p>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).</p> <p>Minimal harmonisation</p>	
<p>Option 2 considered by ESMA when developing the advice</p> <p>Quantitative threshold</p>	<p>Easy to apply a threshold</p>	<p>Need for multiple thresholds, according to the different investment strategies of the AIF</p>	



Option 3 considered by ESMA when developing the advice

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 III – Advice of the Securities and Markets Stakeholder Group

Advice on ESMA's draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive in relation to supervision and third countries

II. EXECUTIVE SUMMARY

The Securities and Markets Stakeholders Group has reviewed ESMA's draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive. This advice distils an impressive amount of work conducted within a compressed timeframe, for which ESMA deserves compliments.

In our analysis of the draft ESMA advice, we have focused on how it contributes to achieving the main purposes of the AIFM directive: anticipate systemic risk and provide the appropriate level of investor protection. The Stakeholder Group has considered if these objectives are achieved in a fit for purpose manner, wherever possible minimizing market impact. This should also allow the right level of tailoring and proportionality for the fundamental diversity and divergence in nature, scale and complexity of the different product offerings to those investors whilst also offering them the protection provided by the AIFM directive.

In this perspective, the Stakeholder Group would like to acknowledge the highly valuable work of ESMA and supports its overall approach of the AIFMD, but also calls for a consideration of a number of specific elements of the draft ESMA advice. Consideration by ESMA should lead to a better balance between market stability and investor protection on the one hand and proportionality and diversity of investment opportunities offered to European investors on the other hand. Currently there are some elements in the Draft Advice that could potentially impact this balance, in particular where certain proposals can appear not to be strictly aligned with the purposes of the AIFM directive, such as more specifically the proposals around (i) the use of equivalence for third country purposes and (ii) the operating conditions regarding risk management, due diligence or internal organizational requirements for managers.

III. INTRODUCTION

19. The Securities and Markets Stakeholders Group welcomes this opportunity to comment on the European Securities and Markets Authority's ("ESMA's") consultation papers on its draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive (the "AIFM Directive") published on July 13 (ESMA/2011/209, the "July

Draft Advice”) and August 23, 2011 (ESMA/2011/270, the “August Draft Advice” and together the “Draft Advice”).⁵⁴

20. The future impact of the AIFM Directive will be vast, not only for fund managers but also for all professional investors in Europe. The Directive will have a big impact on the relationships of the investors with EU and non-EU fund managers – to the extent that the latter market Alternative Investment Funds (AIFs) in the EU – across a very broad range of managers and funds. This ranges from those managing funds that trade in large numbers of liquid financial instruments and market to a diversified investor base, to those with a very limited numbers of professional investors for a limited number of investments into illiquid assets such as unlisted companies, land or real estate.
21. The AIFM Directive is a highly complex piece of legislation resulting from long and detailed negotiations and delegates authority to the European Commission to adopt implementing measures on a large number of issues that are specifically identified in the Level 1 text. It is important that ESMA’s final AIFMD advice (the “Final Advice”), and the Commission’s implementing rules as ultimately adopted, provide a balance between serving as a guidance to industry participants and competent authorities that is as concrete and practical as possible, while staying within the perimeters of the Level 1 text.

Perspective taken by the Stakeholders Group

22. In its analysis of the ESMA draft technical advice, the Stakeholder Group has taken the perspective that its advice to ESMA should focus on getting the balance described under paragraph 3 right, instead of possibly replicating some of the efforts already undertaken by other stakeholders in their more technical responses to the Draft Advice. Two key questions have been identified that could potentially impact the balance:

A. Does the Draft Advice strike the right balance in providing concrete guidance to industry participants and regulators whilst staying in line with the Level 1 text?

The aim should be to have a Final Advice in line with the stated purposes of the AIFM Directive, whilst also considering whether these objectives are achieved to the largest extent possible in a manner which impacts, as little as possible on the diversity and return of the investment opportunities offered to professional European investors. In a number of respects the delicate compromise of the AIFM Directive could be impacted by the Draft Advice which appears in several occasions to go further than what the Level 1 text intended. This could be an inevitable consequence of the high level character of Level 1, but could also lead to unintended consequences.

B. Does the Draft Advice implement the principle of proportionality?

The Stakeholder group has also taken the perspective that the Level 2 text must achieve the high level of protection for European investors – as required by Level 1 - whatever the product in which they invest or the manager with whom they engage, whilst also considering whether the right level of tailoring and proportionality in the rule setting is provided given the fundamental diversity and divergence in nature, scale and complexity of the different alternative investment fund (“AIF”) business models offered to professional investors in Europe. It could be that the Final Advice will benefit from a further consideration of this large divergence of investment fund propositions.

⁵⁴ References in this note to boxes and questions are to the July Draft Advice unless otherwise specified.

IV. EXAMPLES

23. We have included a selection of concrete examples in respect of the Draft Advice for which we believe that answer to question A and/or B above may require reconsideration by ESMA:

Example 1: equivalence

24. Under the requirements for delegation ESMA introduces in Box 1 (*In the event of a delegation of portfolio or risk management to an undertaking in a third country, how co-operation between the home Member State of the AIFM and the supervisory authority of the undertaking should be ensured*) of the August Draft Advice the use of equivalence. This concept is used for determining if the undertaking to which the AIFM is going to delegate is subject to a regime of regulation at least 'equivalent' to that of the AIFMD. Without an equivalent regime, delegation will be difficult. The same applies to the August Draft Advice, which suggests that the regulatory regime of the non-EU depositary must include a liability regime equivalent to that of the AIFM Directive instead of regimes of the 'same effect' as set out in Level 1. The way in which equivalence is dealt with in the Final Advice is also important because this could also have an impact on the way similar concepts in other future European directives or regulations will be interpreted.

25. These equivalence suggestions seem to deviate from the requirements and intentions of Level 1 and could potentially impact the balance referred to in A and B above. In light of the unique nature of the AIFMD regime even undertakings or depositaries in other, well respected, countries with a high level of regulation might not even meet these equivalence tests (e.g. the US). This could potentially make delegation of portfolio or risk management functions to undertakings in third countries difficult.

26. In light of the aim of the AIFM Directive and the balance of the Level 1 text, having equivalence tests introduced at Level 2 could potentially lead to the investors the AIFMD aims to protect not being able to access valuable investments services offered outside of the EU. We hope that ESMA will be able to find a solution that meets both the aims of the AIFM Directive, while not leading to these potential consequences as this would bring no benefit to investors and managers alike. A possible solution could be simply sticking to the current Level 1 text, which could then lead to an effective delegation regime to undertakings in third countries without impeding on the objectives of the AIFMD. Alternatively, the existing UCITS and/or MiFID rules for delegation could perhaps serve as inspiration.

Example 2: preferential treatment

27. The Draft Advice makes suggestions around the types of preferential treatment that could have an overall material disadvantage to other investors and would be qualified as "unfair". However, Level 1 does permit preferential treatment as long as it is disclosed to investors and thereby – so we assume, as derived from the aim of the AIFM Directive – adequately protected. Therefore a suggestion by ESMA needs to be balanced against the comfort that investors draw - as a measure of investor protection- from full disclosure further to Level 1. In terms of the Final Advice we could see an option working whereby ESMA would leave this matter to the Level 1 text only and allow local market practices to take its course based on the high level principle contained in the AIFM Directive.

Example 3: depositary obligations

28. For the depositary to adequately perform its tasks - especially the obligation on the depositary to monitor the subscription and redemption process, it is critical for the depositor to be properly in-

formed, with entails certain information or approval rights. It is to be assessed whether the requirement on depositaries to carry out *ex ante* verifications of certain transactions – including the obligation to check the underlying legal structures of AIFs’ investments and not only the ownership of AIFs’ assets other than financial instruments – is in all instances required from an investor protection point of view. This does not become clear from the explanatory text to the Draft Advice.

Example 4: leverage

29. As the leverage definition in the AIFM Directive is based upon an in-depth analysis of the leverage mechanisms that have the potential or not to create systemic risk, it is critical to ensure at Level 2 that any indebtedness at the level of entities in which an AIF invests, is indeed fully isolated from the AIF and does not increase the exposure at the level of the AIF itself, including the absence of any guarantees given by such AIF for any borrowing at the entity level

Example 5: cooperation arrangements with third-country authorities

30. The AIFM Directive provides that before delegation or marketing is allowed, certain cooperation arrangements with third-country authorities are required. These arrangements must provide for an exchange of information for the purpose of systemic risk oversight. The requirement that this exchange of information should be aimed at the performance of all duties under the AIFM Directive for an EU AIFM manager with a passport, could be reconsidered against the need of such information for systemic risk purposes and the risk of discontinued availability of a wide range of investment choices to EU investors, as such cooperation arrangements must be in effect by mid July 2013.
31. On the other hand, ESMA could provide stronger guidance which will be necessary for the complex system of cooperation arrangements envisaged by the AIFM Directive to operate effectively. The August Draft Advice helpfully suggests that ESMA should negotiate a single agreement with each relevant non-EU jurisdiction for purposes of permitting delegation of portfolio and risk management. However that advice suggests only, as regards the cooperation arrangements required for access to national private placement regimes, that ESMA would prepare a “template” for agreements that would then be negotiated on a bilateral basis which may not be satisfactory in view of the time pressure for such agreements on delegation being place to ensure continued access of European investors to non EU managers.
32. Equally, to ensure a smooth implementation of the third-country aspects of the AIFM Directive, which is critical for European investors, ESMA should assess whether the cooperation agreements contemplated by Article 21(1)(d) and those contemplated by Articles 34(1)(c), 36(1), and 42(1) can be negotiated centrally by ESMA.

Example 6: member state of reference

33. The Level 1 text calls for implementing measures on the procedures to be followed by Member State authorities when determining the Member State of reference where several are possible. The Level 1 text contains no relevant criteria for the most likely case, i.e. where a non-EU AIFM intends to market one or more non-EU AIFs in several or even all Member States.
34. The statement by the Draft Advice that ESMA was unable to identify any criteria to assist in determining the Member State of reference, could be reconsidered against the relevance of criteria such as the selection of a Member State of reference for another AIFM within the same group, the supervi-

sion of members of the AIFM's group by the authorities of a potential Member State of reference, the presence of entities within the AIFM's group in a potential Member State of reference with the capacity to act as legal representative, and the language of the potential Member State of reference versus the operating language of the AIFM.

Example 7: operating conditions: internal structures

35. The detailed requirements to maintain separate compliance and risk management structures and procedures overseen by individuals not compensated based on AIFs' performance, as proposed by the Draft Advice, could be reconsidered against the fact that many AIFMs in accordance with their business models have lean staffs, whereby the ultimate supervisory roles are often occupied by a few very senior individuals who typically co-invest in the AIFs managed by those AIFMs and whose interests ought to be aligned with those of investors. Part of the reconsideration process could be providing guidance how these types of institutions should comply with these requirements in light of the above.

Example 8: operating conditions: risk management

36. While the Draft Advice recognizes the need to tailor risk-management requirements for different business models, the Advice should assess the need to recognize that not all AIFs will be subject to the types of risk as identified in Box 20 (*Types of conflicts of interest between the various actors as referred to in Article 14(1)*), that not all of the arrangements, processes and techniques mentioned in Box 28 (*Measurement and Management of Risk*) will be appropriate for all AIFs and, in the case of AIFs making long-term investments in less liquid assets, quantitative risk measures may not be appropriate.

Example 9: MiFID & UCITS

37. The Draft Advice rightly uses some of the existing concepts under MiFID and UCITS as an inspiration and reference on how to interpret certain AIFM concepts at Level 2. However, given the very broad scope of the AIFMD, these existing UCITS or MiFID rules cannot provide appropriate guidance 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 Level 2 rules should at the same time also 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. It is especially important for ESMA to get this right because many concepts used in the AIFM will in their turn have a 'knock-on effect' on other future European directives, such as UCITS V, MiFID II and EMIR.

V. CONCLUSION

38. In its analysis of the Draft Advice, the Stakeholders Group has focused on how the advice contributes to achieving the purposes of the AIFM directive: anticipate systemic risk and provide the appropriate level of investor protection. In the design of any new regulatory regime there is a risk of unintended consequences, especially where new rules are applied to a diverse industry. Although we feel that much has been accomplished in this respect by ESMA in the Draft Advice, potentially even more could be achieved by keeping a close eye on the fine balance between market stability and investor protection on the one hand and proportionality and diversity of investment opportunities offered to European investors at acceptable costs levels on the other hand. Our conclusion is that cur-



rently there are elements in the Draft Advice that could potentially impact this balance and may require reconsideration.

We would welcome the opportunity to discuss our views at your convenience and hope that these views will help ESMA in balancing its Final Advice.

This advice will be published on ESMA's website.

Adopted on 27 October 2011

Guillaume Prache
Chair
Securities and Markets Stakeholder Group

Annex IV – Feedback on the consultations

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

General comments

2. A number of general comments were made on the advice. Some respondents welcomed the consistency that had been achieved with UCITS and MiFID. Others felt that a principles-based approach should be favoured as much as possible. One investment management association also called for the Level 2 provisions to be designed with professional investors in mind.
3. Some more negative points were made with respect to the advice as a whole. One association stressed that ESMA should pay close attention to remaining within the scope of the Commission's request (c.f. Box 19 on delegation or the Transparency requirements) and felt that some of the boxes lacked clarity and would benefit from introduction of the explanatory text into the box. One institutional investor representative went further, stating that in some areas of the advice, the wording made compliance almost impossible to achieve and should be reconsidered (e.g. the requirement in paragraph 1 of Box 26 to identify all relevant risks to which the AIF might be exposed). Two investment management associations considered, meanwhile, that the draft advice had been prepared with externally-managed AIFs in mind and was not always suitable for internally-managed AIFs.
4. There were a number of requests for greater proportionality and differentiation, whether in general or in relation to specific areas such as the requirements on additional own funds and reporting obligations. Private equity representatives stressed the need to take account of private equity (PE) funds, while real estate representatives made similar requests for real estate (RE) funds.
5. Looking further ahead, two respondents expressed their view that the implementing measures should take the form of directives, perhaps with the exception of the reporting requirements to competent authorities (CAs). As for the work to be done on the technical standards required under Article 4(4) of the Directive, one investment management association encouraged ESMA to seek industry input to its work on developing a typology of AIFs.
6. Two RE associations requested an explicit statement from ESMA and/or the Commission that the Directive does not apply to property companies.

Part III: Article 3 exemptions

Box 155

⁵⁵ The numbering of the Boxes in this section reflects the consultation papers published in July and August respectively, unless otherwise stated.

1. Several respondents agreed that the appropriate approach to calculating assets under management was to identify those AIFs for which managers was the AIFM and then to aggregate the asset under management of those AIF. Respondents also agreed that AIFM should exclude from the assets under management calculation crossholdings in other AIFs managed by the same AIFM.
2. Several respondents proposed that a period of 3 months for qualifying a situation of temporary nature was too short and should be extended to 6 months.
3. It was also suggested by some contributors that notifications to competent authorities should only be sent when AIFM believe that the situation of assets under management above the threshold was not a situation of a temporary nature.

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

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

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

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

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

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

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

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

7. According to one stakeholder, private equity and venture capital managers should be given an alternative approach. According to this stakeholder, a more appropriate method for calculating the total value of assets under management for private equity and venture capital managers would be to take the acquisition cost of all investments less the acquisition cost of investments realised and of investments that have been written off since.
8. For several respondents, the use of the NAV was not an appropriate measure for all types of AIFs due to the wide range of funds that fall into the scope of the AIFMD.
9. On the contrary, other contributors were of the view that the net asset value was an appropriate measure of asset under management which according to them necessarily reflects the value of any assets acquired through leverage. Some of these respondents agreed that for many AIFs, the net asset value was an appropriate measure but stressed that the methodologies to calculate the net asset value should be done according relevant national rules and recognised accounting standards.

ESMA's response: ESMA carefully analysed the comments received during the public consultation and decided to change the approach for the calculation of the total value of assets under management. Indeed, many respondents felt that the use of the net asset value for the calculation of the total value of assets under management would not be practicable for many AIFM investing in non-liquid or non-listed assets like private equity AIFs. Therefore, ESMA recommends that the calculation of the total value of assets under management should be based on asset valuation and does not prescribe what the methods for these valuations should be except for derivative positions. Indeed, ESMA strongly believes that derivatives positions entered into by AIFM should be converted into their equivalent position in the underlying asset of that derivative and should not be taken for their market value. Moreover, as proposed in the consultation paper, the calculation should be performed at least annually using asset value calculation that are not older than 12 months. As regards the evolution of the total value of assets under management between two annual calculations, ESMA recommends that AIFM must apply on on-going basis procedures that allow them to monitor the value of their assets under management. Therefore, AIFM should not systemically recalculate on a regular basis the total value of assets under management but rather monitor different factors like subscriptions and redemptions, capital drawdowns or the value of the assets and if, based on these observations they believe that the total value of assets under management, perform a new calculation.

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

10. One respondent noted that large managers which were fully subject to the AIFMD would only be required to value their asset under management annually (where, as is the case for private equity and venture capital funds, they are closed ended funds which do not issue or redeem units). Therefore, this respondent suggested that the same should apply to smaller managers of closed ended funds, at least those which do not invest predominantly in 'assets that must be held in custody' and/or generally invest in issuers or non-listed companies in order to potentially acquire control. However, this contributor would accept half-yearly monitoring and proposed that private equity and venture capital AIFM should not be required to assess market fluctuations or possible changes in the value of individual assets as it was a long and complex exercise to value a private equity or venture capital asset.

11. For another respondent, an increase of the value of asset under management due to market exposure should not generally require a recalculation unless there was evidence that this was an established trend.
12. It was also pointed out that situations like large redemption orders, assets written-down or written off would be situations for which there should not be re-calculation of the value of total assets under management.

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

13. The vast majority of respondents to the consultation disagreed with this proposal and believed that AIFs which are exempt under Article 61 of the Directive should not be included when calculating the threshold.

ESMA's response: Based on the feedback received from the consultation, ESMA recommends that AIFs which are exempt under Article 61 of the AIFMD should not be included when calculating the threshold.

Box 2: Calculation of leverage

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

14. In general, this proposal was not supported by respondents to the consultation.
15. For one respondent it was difficult to understand why for the purpose of calculating the asset under management the leverage should be computed using the gross method. According to this respondent, the mere concept of taking gross exposure did not seem to fit very well with a calculation of assets under management which is generally proposed to be made on a net basis.
16. Several contributors also disagreed with the proposition to include the gross exposure in the calculation of the value of assets under management because the net asset value already includes the value of instruments acquired through leverage.
17. It was also pointed out that this proposal was not consistent with the part of the consultation paper on the calculation of leverage which allows for different methods. Also, it was stressed that including gross leverage would be misleading because investors and industry participants have a clear understanding of the term asset under management as meaning assets under management from investors. Moreover, the inclusion of gross leverage in the calculation of the total value of assets under management would bring many small AIFs and AIFMs into the Directive.

ESMA's response: ESMA decided to delete the Box 2 related to the calculation of the leverage in the final advice and to incorporate the relevant provisions in Box 1. However, as explained above, ESMA modified the approach for assets acquired through leverage. Hence, ESMA no longer recommends that AIFM should calculate the leverage according to the gross method when calculating the total value of assets under management. Instead, ESMA believes that derivatives instruments should

be converted into their equivalent position in the underlying asset and added to the value of the other investments made by the AIF. Indeed, if derivative positions were treated at their market value this could lead to situations where small AIFM that extensively make use of financial derivatives instruments are not captured by the AIFMD even if their exposure to the market (after conversion of the derivative position) is the same as AIFMs which directly invest in the underlying assets and which are subject to the Directive.

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

18. A majority of respondents to the consultation were in favour of this proposal.

19. Some respondents pointed out that, if the calculation of the total value of assets under management was based on the NAV as proposed by ESMA, the value of foreign exchange or interest rate hedging positions would be necessarily reflected in the NAV of the relevant AIF.

ESMA's response: In light of the feedback received, ESMA decided to exclude from the calculation of the total value of assets under management derivative positions when they are used to for currency and interest rate hedging and are not part of the investment strategy of the AIF to generate return.

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

20. In general respondents to the consultation felt the proposed requirements for calculating the total value of asset under management clear although many of them disagreed with the treatment of gross exposure which, according them was a different concept from the total value of asset under management.

21. Some stakeholders felt paragraph 5 too prescriptive and disagreed with the 3-month period and proposed a 12-month period instead (i.e. to wait until the next calculation).

22. ESMA was also asked to specify that for AIFM investing in physical assets, different methodologies could be used as the income value approach for instance.

ESMA's response: As explained above, Boxes 1 and 2 have been merged into a single Box 1 and the treatment of derivatives instruments clarified.

Box 3: Information to be provided as part of registration

23. Many respondents expressed some concern about the requirement to report on a quarterly basis to competent authorities.

24. It was also suggested that competent authorities should not have the possibility to request information on a more frequent basis than determined in paragraph 4 of Box 3 and therefore asked for the deletion of paragraph 5. Some stakeholders believed that the word 'at least' in paragraph 2 of Box 3 should be deleted in order to ensure a harmonisation at EU level.

25. It was also suggested that the update should be done in case of material changes to the risk profile. Otherwise a reporting on an annual basis should be enough.

ESMA's response: Based on the comments received, ESMA has decided to amend the approach and recommends in the final advice that the information under Article 3(3) (d) should be provided on an annual basis rather than on a quarterly basis as proposed in the consultation paper.

Box 4: Opt-in procedures

26. There was a general support from stakeholders on the approach proposed by ESMA for opt-in procedures.

ESMA's response: In light of the general support from respondents to the consultation, ESMA did not modify the advice concerning opt-in procedures.

Box 5: AIFMs falling below the threshold

27. There was a general support from respondents to the consultation on Box 5.

28. However, it was proposed that the provisions would be better expressed as simple requirements only to take action if the AIFM wishes to seek exemption.

ESMA's response: Following the general support expressed from respondents to the consultation, ESMA did not modify the advice concerning opt-in procedures

Part IV: General operating conditions

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

General comments

29. Asset managers' and insurers' representatives expressed a general comment according to which the possible implementing measures on additional own funds and professional indemnity insurance (PII) were not appropriate for internally managed AIF and raised a number of practical questions:

- it was unclear how the additional own funds should be raised;
- it was unclear whether the additional own funds may be a part of the AIF's assets being invested or should be segregated from the other assets of the AIF;
- for closed-ended internally managed AIF, it was unclear how they should raise the additional own funds or adjust them during their life.

30. The same asset managers' representatives recognised that these issues came from the provisions in Level 1 and mentioned that they could be solved by amending article 9(6) of the AIFMD to provide for a waiver from the additional own funds requirement in case they benefit from a guarantee for 100% of the additional amount of own funds.

31. As a consequence of this situation, asset managers' and insurers' representatives called for the introduction of the possibility for AIFM to use a combination of additional own funds and PII. Furthermore, asset managers' representatives requested to provide for a cap on the additional own funds reflecting the EUR 10 million's cap for the own funds.
32. Some institutional investors asked to clarify that in case of self-managed AIFs operating with a board of directors that delegates functions to qualified third parties and do not have employees per se it would be permissible to have directors' liability insurance cover rather than PII cover.
33. Some insurers' representatives mentioned that, given the limited availabilities in this market, there will likely be an inadequate amount of insurance capacity to fulfil the demand for PII that will be brought about by the AIFMD rules; whereas remaining in opposition to the requirements of Article 9 of the AIFMD, they recommended that Article 9 should remain as flexible and broad as possible so as not to unduly hinder insurance market capacity for the cover of potential claims.

ESMA's response: ESMA saw merit in the requests for introducing the possibility to have a combination of additional own funds and professional indemnity insurance, in particular given both the inappropriateness of the additional own funds for internally managed AIFs and the claims that there would likely be an inadequate amount of insurance capacity to fulfil the demand for PII that will arise as a consequence of the new rules. ESMA advice foresees the possibility to combine the additional own funds and the PII and sets out the rules to be followed for determining the respective amount of additional own funds and coverage of PII in case of combination.

ESMA did not follow the request of introducing a cap for the additional own funds required under Article 9(7) of the AIFMD since this would have resulted in an unjustified advantage to bigger AIFMs.

ESMA considered that directors' liability insurance cover may not replace the PII cover which was prescribed to AIFM by the AIFMD.

Box 6 – Potential risks arising from professional negligence to be covered by additional own funds or professional indemnity insurance

34. Private equity managers encouraged ESMA to consult with the EU insurance market in order to establish whether insurers will be prepared to offer policies of the type covered by ESMA's proposal and to clarify how PII policy should be drafted in order to comply with the relevant requirements.
35. The same private equity managers asked for the introduction of a transitional period during which AIFMs would be required to obtain PII meeting the relevant requirements insofar as they are able to obtain qualifying PII in their member state or elsewhere in Europe.
36. Real estate representatives asked for specific guidance on the risks that managers of non-listed real estate funds are liable for.
37. Several asset managers were against the obligation of coverage of losses arising from all 'relevant persons', including those who provide services under a delegation agreement. Some of them mentioned that it is very difficult to implement this to the extent that the AIFM is normally not aware of all the risks of the delegate. Others suggested the replacement of the reference to 'relevant persons' with a reference to 'AIFM's staff'. Private equity managers argued that the wide definition of 'delegation' in the definition of 'relevant persons' meant that the PII would have to cover both (i) service pro-

viders for whom an AIFM has vicarious liability (i.e. third parties who act on behalf of the AIFM for which an AIFM has liability) and (ii) service providers for whom an AIFM does not have vicarious liability, whereas AIFM would be unable to purchase PII which cover persons falling under (ii); thus, they proposed to replace the reference to ‘relevant persons’ with a reference to ‘the AIFM’s directors, officers or staff or third parties for whom the AIFM has vicarious liability’.

38. In order to avoid a double coverage at the level of both the AIFM and the delegate, several asset managers asked for amending Box 6 in order to exclude the risks of the delegate if the latter holds an own sufficient indemnity insurance. Some of them and also some insurers suggested requiring AIFM to have appropriate coverage only where the loss arises due to negligence of the AIFM in appointing and supervising the delegate. Similarly, other asset managers asked to clarify that risks need not to be insured where they fall within the responsibility of a supplier who has its own insurance and requested to accordingly amend the reference to ‘legal responsibility’ included in the first sentence of paragraph 2 of Box 6. Certain insurers suggested that the activities for which the AIFM has ‘legal responsibility’ should be limited to those listed in Annex 1 of the AIFMD.
39. Several asset managers and insurers asked to delete paragraph 2(a) of Box 6 since potential liability of an AIFM should be restricted to risks arising from negligence, not including the risks arising from fraud, which are not mentioned in article 9 of the AIFMD. Private equity managers mentioned that PII can provide limited extent of cover in relation to fraud, dishonest acts and malicious acts and were of the opinion that the coverage of risks in relation to fraud was beyond the requirements of the Level 1 Directive. Insurers’ representatives mentioned fraud among the perils which are traditionally assumed as uninsurable under a liability policy.
40. Some asset managers suggested amending paragraph 2(c) of Box 6 in order to align it to the current practice of the insurance industry which provides that losses resulting from mechanical failures are excluded from insurance coverage, unless the loss is a result of an intervention or manipulation of the staff of the AIFM.
41. Several asset managers requested the deletion of paragraph 2(c) of Box 6 since business disruption and system failures are not an AIFM professional negligence issue and are outside the scope of the Level 1 directive. Some of them added that these issues are already covered by paragraph 2(b) of Box 6.
42. Hedge funds managers suggested not making the requirements of Box 6 mandatory, but requiring AIFM and competent authorities to ‘have regard to’ the list of issues in Box 6 since in a number of EU jurisdictions (other than the UK) there is no developed market for PII for AIFMs.

ESMA’s response: The suggestion made by some stakeholders to exclude the losses arising from entities providing services to the AIFM under a delegation agreement or to limit the liability of the AIFM to the cases of negligence in appointing and supervising the delegate was not taken into account. Indeed, according to Article 20(3) of the AIFMD, the liability of the AIFM shall not be affected by the fact that it has delegated functions to a third party, or by any further sub-delegation. However, ESMA agreed on clarifying that the liability of the AIFM shall be limited to the AIFM’s directors, officers or staff or third parties for whom the AIFM has vicarious liability.

ESMA recognised that fraud as such is not an insurable risk and decided to clarify that the losses linked to fraud which the AIFM is responsible for are only those arising from the failure by the senior

management of the AIFM to put in place procedures to prevent dishonest, fraudulent or malicious acts within the AIFM's organisation.

On the request aiming at the exclusion of the losses resulting from mechanical failures from insurance coverage, ESMA acknowledged that according to the current practice of the insurance industry such losses are usually excluded from insurance coverage. Nevertheless, ESMA maintained its view that mechanical failures shall also adequately be covered since they may represent an important source of losses for the AIFM.

ESMA did not consider appropriate to introduce any grandfathering provisions on the PII requirements also taking into account that there was no empowerment in that connection within the AIFMD.

As for the risks that managers of non-listed real estate funds are liable for there is no need of any specific guidance since the risks for which the AIFM is liable for are applicable to all kind of AIFM.

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

43. Some asset managers considered the rule feasible, but very far going. Since it is not necessary to require a double layer of safeguards at the level of the AIFM and at the level of the external valuer, they asked making due allowance for adequate capital backing or insurance coverage provided by the external valuer.

44. The majority of asset managers and some representatives of insurers did not consider feasible and/or practicable for an AIFM to obtain PII in relation to the valuation performed by an external valuer since the AIFM should be liable for the negligent selection of an external valuer and be able to purchase PII to cover breach of its professional duties when appointing the external valuer, but not to cover the negligent acts by a third party; one respondent also added that if insurance were required to cover improper valuation of assets, the problem of 'double coverage' would arise.

ESMA's response: ESMA did not consider appropriate to exclude from the risks to be covered the valuation performed by an appointed external valuer since according to Article 19(10) of the AIFMD, the liability of the AIFM shall not be affected by the fact that it has appointed an external valuer.

Box 7 – Qualitative Requirements (based on Annex X Directive Part 3 2006/48/EC)

45. A minority of asset managers supported the notion of establishing a historical loss database at the AIFM level.

46. Some respondents asked to clarify that the reference to a 'historical loss database' requires recording only of material losses arising from significant operational failures and not of any losses experienced (for instance, even those arising as a result of normal investment activity).

47. While recognising the benefits of collecting and retaining loss data as means of understanding potential liabilities arising from professional negligence, some institutional investors' representatives made a general comment arguing that AIFMs should be free to determine and implement a risk management strategy which reflects their size and internal organisation and the nature, scale and complexity of their activities. As for the requirement according to which risk management activities should be

performed independently, the same institutional investors' representatives recommended that any rules should allow and specifically support a 'three lines of defence' model (based on a first line management function, a second line risk function and a third line internal audit function) which is a typical model of risk management.

48. The majority of asset managers advocated that the 'Advanced Measurement Approach' was deleted from the proposal. Some of them mentioned that no AIFM would have sufficient historic loss data to make use of this methodology. Others pointed out that AIFMs presented a completely different type of risk as compared to credit institutions and investment firms and it would not make sense to apply the 'Advanced Measurement Approach' policy to meet the risks posed by AIFM. Private equity managers also mentioned that (i) the approach related to an operational risk requirement and there was no mention to such a requirement in the AIFMD and (ii) the 'Advanced Measurement Approach' concept had so far only been applied to credit institutions and to investment firms which deal on own account or underwrite.

49. Some of the asset managers not supporting the proposal on the 'Advanced Measurement Approach' suggested that the reference to operational risk (if kept) should be limited to an obligation to implement risk management facilities reflecting the size and internal organisation of the AIFM, and the nature, scale and complexity of its activities.

50. Some respondents pointed out that the AIFMD did not provide for any obligation for AIFM to measure, manage or mitigate operational risk. In order to ensure that Level 2 provisions do not go beyond the AIFMD, some of such respondents recommended a clarification that the requirement to 'maintain a separate operational risk management function' refers exclusively to the provisions set out in Box 30 and does not require establishing a separate function for managing risks relating to operational liability.

ESMA's response: ESMA acknowledged the concerns expressed by the industry on the difficulties to set out a 'historical loss database' for the AIFM. However, ESMA maintained its approach since it considered important to mitigate operational failures and liabilities through the implementation of appropriate internal control mechanisms for operational risks, including the building up of an internal loss database as basis for the assessment of the operational risk profile of the AIFM.

51. As for the absence of any reference to the operational risks requirements under the AIFMD, ESMA recalls that Article 24(2)(c) of the AIFMD explicitly refers to operational risk as one of the risks to be managed by the risk management systems employed by the AIFM. ESMA did not consider appropriate to refer to the proportionality principle in relation to operational risks.

Box 8 – Quantitative Requirements

52. The very large majority of respondents preferred option 1 under Box 8. A small minority of respondents either preferred option 2 or recommended that both option 1 and option 2 should be made available to an AIFM.

53. Some of the asset managers preferring option 1 mentioned that there was no logical link between the liability risk and the income of an AIFM foreseen under option 2. The same asset managers explained that option 2 was more complicated and left wide room for diverging interpretations by the different competent authorities, in particular in relation to the 'relevant income', which was also difficult and cumbersome to determine in practice. A respondent mentioned that it should be guaranteed that the

liability risk of 0,01% remained fixed and should not be increased over time. Another respondent mentioned that its preference for option 1 was justified by the fact that the risks covered by the CRD are not comparable with the risks which may be incurred in the management of non-tradable closed-ended funds.

54. Among the respondents preferring option 1, certain critics were made to the rules set out by such option. Private equity representatives mentioned that no objective rationale was provided for the level of additional own funds based on assets under management and that one effect of the own funds requirements will be to decrease the amount of money which is available to individual executives for investment into AIFs. Some asset managers' representatives asked for significantly lowering the quantitative requirements for both options; indeed, in both cases, the requirements seemed to them very high compared to historical loss data.

55. Private equity representatives proposed that AIFMs have up to 6 months to finalise the revised figures, due to the gap between the end of the financial year and the date on which the updated fund valuation is available/reported.

56. Several asset managers' representatives agreed with the proposal that national competent authorities shall have the power to lower the additional own funds requirements, whereas other asset managers' representatives were of the opinion that this could lead to regulatory arbitrage and market distortions between member states and suggested that the power should be exercised by ESMA.

ESMA's response: Given the broad support for option 1, ESMA decided to choose such option and not to include the income of the AIFM as a proxy for liability risk.

57. ESMA believed that the quantitative requirement set out in option 1 was appropriate and that there was no need for lowering it, also considering the flexibility given by the newly introduced possibility of combining the additional own funds and the PII.

58. ESMA did not consider necessary to introduce a timeframe for the yearly recalculation and adjustment of the additional own funds.

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

59. The vast majority of respondents considered that the term 'relevant income' should not include performance fees. Some of the respondents explained that there is no direct link between an increase of such fees and an increase of risk and that the level of fees received was an appropriate approximation to determine the risk of professional negligence posed by an AIFM; furthermore, for some asset managers, this would entail a change of the own funds of the AIFM from year to year, notwithstanding the fact that risks remained constant. Some institutional investors' representatives added that for self-managed AIFs the only income received will be from investments as the AIFM would not receive income in relation to collective portfolio management activities or from any other source. A stakeholder also mentioned that the inclusion of relevant income solution would give misleading impression of volatility in relevant income, as performance fees are not typically paid out on an annual basis but are carried over.

60. A very minor set of respondents considered feasible and practicable that the term 'relevant income' included performance fees.

ESMA's response: Given that ESMA choose option 1 under Box 8, the reference to the 'relevant income' was no longer relevant since deleted from the provisions of Box 8.

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

61. The vast majority of respondents considered that the term 'relevant income' should not include the sums of commissions and fees payable in relation to collective portfolio management activities and several respondents reiterated that the use of income should not be made for approximating professional liability risk.

ESMA's response: Given that ESMA choose option 1 under Box 8, the reference to the 'relevant income' was no longer relevant since deleted from the provisions of Box 8.

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

62. Few respondents provided some useful empirical evidence predominantly showing that option 2 would result in a significantly higher requirement and thus helping ESMA in reaching its final decision to retain option 1.

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

63. The majority of respondents considered that the 'Advanced Measurement Approach' should not be used. Some of them mentioned that the processes used by credit institutions have nothing in common with the activities of an AIFM and only large AIFM allied with banks would be able to provide the figures required. Other respondents did not see any need for allowing for the 'Advanced Measurement Approach' as an optional framework on the basis that within the AIFMD there was no specific obligation placed on an AIFM to manage operational risk.

64. Private equity representatives mentioned that it was unclear whether AIFMs should record data from 22 July 2013 or whether the requirement to hold such data would apply retrospectively.

ESMA's response: As explained above, ESMA decided to maintain its approach since it considered important to mitigate operational failures and liabilities through the implementation of appropriate internal control mechanisms for operational risks, including the building up of an internal loss database as basis for the assessment of the operational risk profile of the AIFM.

ESMA based its advice on the assumption that the relevant AIFMD rules should start to be applied as of 22 July 2013.

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

65. Some asset managers' representatives were of the opinion that the minimum historical observation period of five years should be reduced, for example to three years: they considered that a five-year period would prevent AIFM with a shorter track record from applying for reduction of capital requirements.
66. Other asset managers considered that the five-year period was appropriate and should not be extended as it would be a sufficiently long period of time for an AIFM to demonstrate that it is capable of performing its duties correctly.
67. A respondent suggested that a '3 years or more' period should be introduced with the possibility for AIFMs which have been in existence for less than 3 years to consider data which cover the entirety of their existence.
68. Some stakeholders suggested that, in line with article 9(6) of the AIFMD, a reduction of 50% of the additional funds should be possible if the AIFM benefits from a guarantee of the same amount given by a credit institution or an insurance undertaking.

ESMA's response: In light of the comments received from stakeholders, ESMA considered appropriate to shorten the five-year period to a three-year period, in order to allow AIFM with a track record shorter than five years, but reasonably acceptable to adequately observe the historical loss data of the AIFM, to apply for lowering the percentage of additional own funds. ESMA came to this conclusion also considering that the lower percentage of additional own funds is not granted automatically, but is subject to the approval of the competent authority of the home Member State of the AIFM.

ESMA did not include the possibility to reduce of 50% the additional funds if the AIFM benefited from a guarantee of the same amount given by a credit institution or an insurance undertaking since it considered that the concerns related to the difficulties to comply with the additional own funds requirements were already sufficiently addressed by the possibility to combine the additional own funds and the PII according to the rules set out under the new Box 9 of the advice.

Box 9 – Professional Indemnity Insurance

69. Several asset managers' representatives considered that the reference to 'relevant persons' in paragraph 1(b) of Box 9 was excessive, given the broad definition of 'relevant persons'.
70. The majority of respondents asked to amend paragraph 1(c) of Box 9 taking into account that in practice insurance policies do not cover all the risks mentioned in Box 6, they usually set out exclusions and limits and often several insurances are concluded each covering only a portion of the risks. Insurers' representatives confirmed that each insurance policy contains a set of limits of indemnity that minimises to what extent cover can be offered to professional indemnity risks and also provided examples of areas that are not likely to be covered by PII.
71. Some respondents mentioned that the wording of paragraph 1(d) of Box 9 was unclear.
72. Some asset managers' representatives suggested that the first sentence under paragraph 1(e) of Box 9 should stop after the words 'ongoing supervision' since for regulated insurance companies it should not be the task of the AIFM to assess the ability of the insurance company to pay claims and there should be a presumption of solvability.

73. Several respondents objected to the different treatment which ‘affiliated’ insurance companies are subject to according to paragraph 1(f) of Box 9 arguing that to the extent these entities are subject to the same prudential rules which ‘independent’ insurance companies are subject to, there should be no different treatment.

74. Some asset managers’ representatives asked for a harmonisation of the frequency of the review which shall be conducted once a year and requested the deletion of the words ‘at least’ from paragraph 4 of Box 9; in addition, they argued that the review should occur in the event of any ‘material’ change and not in the event of any change (paragraph 4 of Box 9). Other asset managers’ representatives suggested a list of changes which the review should be restricted to.

75. Private equity representatives supported an annual review by the AIFM since easier to enforce.

ESMA’s response: As explained above, the reference to the ‘relevant persons’ has been replaced with a reference to the AIFM’s directors, officers or staff or third parties for whom the AIFM has vicarious liability.

76. Considering the comments received from respondents, ESMA saw merit in amending paragraph 1(c) of Box 9 in order not to impede the standard exclusions and limits set out under insurance policies and also clearly recognised that several insurance policies may be concluded each covering only a portion of the risks, provided that overall all the relevant liability risks are covered and the required minimum coverage are ensured.

77. Further to the respondents’ request for clarification, ESMA considered appropriate to modify the content of paragraph 1(d) of Box 9 to clarify that the own funds which shall be covered any excess under the insurance policy are in addition to the own funds to be provided according to Articles 9(3) and 9(7)(a) of the AIFMD.

78. ESMA saw merit in providing for an assumption of solvability for EU regulated insurance undertaking, but decided to require that in case of third country insurance undertakings, the AIFM would have to demonstrate to the competent authority that the insurance undertaking has sufficient financial strength with regard to the claims paying ability.

79. ESMA recognised that there were no reasons for imposing a different treatment to ‘affiliated’ insurance companies since these entities are indeed subject to the same prudential rules which ‘independent’ insurance companies are subject to.

80. Finally, as for the frequency of the review, notwithstanding the comments received from some of the respondents, ESMA decided not to make any change to the provisions of the advice since these provisions require an appropriate mechanism according to which the review is in principle annual, but may be more frequent in case of any change which affects the compliance of the policy with the requirements. The reference to the ‘materiality’ of the changes was considered not necessary to the extent that according to the relevant provisions the review is triggered not by any change, but only by those which affect the compliance of the policy with the requirements.

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

€3.5 m, while for more than 100 investors, the amount in paragraph 3 (b) would be increased e.g. to €4 m.

81. The very large majority of respondents were of the opinion that the number of investors should not have any influence on the amount to be covered by the insurance and that one loss should lead to one event/claim in the insurance policy independently of the number of investors. A respondent mentioned that the existing minimum amounts for single claims were too high for non-tradable closed-ended funds, whereas the insurance amount for total claims per year was appropriate.

ESMA's response: In light of the comments received from respondents who clearly rejected the option of modifying the minimum coverage amounts to take into consideration the number of investors, ESMA decided not to introduce any amendment to the minimum coverage amounts.

IV.I. Possible Implementing Measures on General Principles

Box 10 – Duty to act in the best interests of the AIF or the investors of the AIF and the integrity of the market

82. Some asset managers' representatives agreed with the proposal in paragraph 1 of Box 10, but claimed for the adoption of a horizontal legislation introducing a level playing field since for the time being only UCITS management companies and AIFM are subject to such kind of obligations.

83. Some real estate and private equity representatives mentioned that, for real estate investments, transactions are negotiated bilateral deals and, therefore, asked for introducing the proportionality principle in Box 10.

84. Private equity representatives also mentioned that it was unclear what undue costs referred to in a private equity/venture capital framework where no trades took place: they therefore asked to limit the scope of paragraph 2 to those AIFM 'managing AIFs which are trading with securities'.

ESMA's response: ESMA decided not to take into account the claims for the application of the proportionality principle as regards the requirements under Box 10 since these are behavioural and not organisational requirements and should therefore apply whichever the size of the AIFM and the nature of its business are.

85. ESMA did not consider appropriate to carve out any specific kind of funds from the relevant requirements since undue costs might be charged whichever the assets into which the AIF invests are.

Box 11 – Due Diligence requirements

86. On paragraph 1 of Box 11, private equity and venture capital representatives objected that for private equity and venture capital managers an investment decision is a very subjective matter, there is no right level of due diligence to be applied and a 'high' level of due diligence should not be required in all circumstances; they proposed that the level of due diligence undertaken be consistent with the risk management policy of the AIF and also asked for deleting the reference to acting in the best interest of the AIF's investors.

87. The same private equity and venture capital representatives mentioned that it was unclear what the AIFM's qualifications to be met according to paragraph 2 of Box 11 referred to and suggested deleting paragraph 2.

88. Institutional investors' representatives requested to clarify in the text of Box 11 that the requirements in its paragraph 4 apply only where appropriate, i.e. for real estate and private equity vehicles and asked to amend the wording of paragraph 4(c) to include that this should be completed on a 'best endeavours' basis.

89. A large number of respondents suggested that paragraphs 4 and 5 of Box 11 should require that only evidence regarding significant investments, not investment opportunities should be kept.

90. One respondent mentioned that Box 11 established additional, disproportionate due diligence obligations.

ESMA's response: ESMA did not consider appropriate to carve out any specific kind of funds from the relevant due diligence requirements since those should be complied with by any kind of funds to the extent they may be applicable to their activities.

91. ESMA considered that paragraph 2 of Box 11 provided sufficient details on the AIFM's qualifications to be met and did not agree on the deletion of these provisions.

92. ESMA considered there was no need to further clarify that paragraph 4 of Box 11 was relevant only for real estate and private equity funds, since the provisions of paragraph 4 of Box 11 already explicitly stated that the relevant requirement were relevant only where applicable to the type of the assets which the fund is invested into.

93. ESMA decided to keep the reference to the requirement to keep evidence of investment opportunities to the extent that the requirement is limited to the significant ones and not to any kind of investment opportunity examined or considered.

94. ESMA believed that the due diligence requirements of Box 11 were not disproportionate since in line with the UCITS approach with due adaptations for AIF investing in specific type of assets.

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

95. A large amount of respondents did not agree with the use of the term 'business plan' and proposed several alternative terms (e.g. 'investment proposal(s)', 'investment policy(ies)', 'risk appetite statements', 'investment plan').

96. The minority of respondents agreed that the term 'business plan' could be used.

ESMA's response: Notwithstanding the fact that the term 'business plan' was not favoured by most of respondents, ESMA preferred to keep the reference to such term 'business plan' since the consultation did not evidence any largely agreed alternative term to be used.

Box 12 – Reporting obligations in respect of execution of subscription and redemption orders

97. In order to reflect the specificities of the private equity/venture capital and real estate sectors, several representatives of such sectors suggested amending Box 12 to include a statement that where an investor has been provided with a subscription agreement or deed of adherence which states the amount of the customer's subscription in a fund, the subscription requirement should be satisfied.

98. Some respondents mentioned that where the subscription or redemption orders are processed by a third party (e.g. a third party distributor) and not by the AIFM, it should rather be the respective third party obligation to comply with these reporting requirements.

ESMA's response: ESMA saw merit in amending the provisions of Box 12 to cover the specificities of the subscription methods in private equity, venture capital and real estate funds. ESMA decided to also amend the box to cover the cases where the subscription or redemption orders are processed by a third party and provided that in such cases the reporting obligations would not apply to the AIFM, to the extent that the third party is obliged to provide the investor with a confirmation of the order including the essential information and the third party complied with such obligation.

Box 13 – Selection and appointment of counterparties and prime brokers

99. Several asset managers' representatives proposed to delete the reference to counterparties in paragraph 1 of Box 13 since it was not mandated by article 14(3) of the AIFMD and thus it was outside of the scope of the Level 1 directive. Some depositaries' representatives suggested enlarging the scope of eligible counterparties under paragraph 3 in order to include clearing brokers for exchange traded derivatives as well as counterparties for time deposit and for securities lending transactions.

100. Private equity representatives asked clarifying that the counterparty referred to in Box 13 was a financial sector transactional counterparty providing services to the AIF.

101. Some depositaries' representatives suggested that the text of Box 13 should oblige the AIFM which appoints counterparties and prime brokers with similar duties as described under Box 75 to ensure that the depository receives from counterparties and prime brokers the information it may require in order to discharge its duties and obligations of safekeeping and oversight. In addition, they suggested the following further changes relating to the appointment of prime brokers:

- (i) either it should be clarified that prime brokers are subject to similar requirements as for any third party where cash accounts are opened (i.e. entities referred to in article 18(1)(a) to (c) of the Directive 2006/73/EC or another entity of the same nature in the relevant market where the prime broker is located) or in the case of appointment of a prime broker Box 76 shall not apply; and
- (ii) in case of re-use of the AIF's assets by a prime broker, appropriate disclosure of such re-use and inherent risks shall be made in the prospectus, in order to be consistent with the depository's obligations under paragraph 8 of Box 74.

102. Real estate representatives pointed out that the use of counterparties and prime brokers is relatively uncommon in non-listed real estate funds, except in the case of interest rate hedging, where the

bank providing the loan requires the hedge to take place with a specific broker acting as counterparty, thus reducing the capacity of the fund to select the counterparties or prime broker.

103. Some respondents suggested modifying paragraph 1 of Box 13 in order:

- to limit the range of services to be considered when selecting and appointing a counterparty to the limited services the AIFM would like to mandate the counterparty for and not the full range of services provided by the counterparty, and
- to consider sufficient that counterparties and prime brokers are subject to authorisation and supervision in their jurisdiction (i.e. it shall not be required an ongoing supervision in any jurisdiction in which the counterparty is active).

104. Some asset managers representatives suggested modifying paragraph 3 of Box 13 to ‘counterparty of an AIFM or AIF’ as in practice the relevant contracts are concluded in the name of the AIF or the AIFM.

ESMA’s response: As for the claimed absence of adequate coverage of the provisions of Box 13 in the Level 1 Directive, ESMA considered that Article 12(1)(a) of the AIFMD, even if not mentioning counterparties and prime brokers, provided an adequate legal basis for the provisions of Box 13.

ESMA was of the opinion that no additional clarifications were required as for the definition of counterparty provided in Box 13.

ESMA recognised the merit of the comments made by some depositaries’ representatives in relation to the information to be received by the depositaries from counterparties and prime brokers and addressed the relevant concerns in a new Box 82.

ESMA did not limit the conditions for the selection and appointment of counterparties since it considered that an AIFM should globally look at a counterparty to be appointed considering the full range and quality of its services.

Finally, ESMA agreed to modify paragraph 3 of Box 13 to ‘counterparty of an AIFM or AIF’.

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

105. Private equity representatives asked to delete the reference to the investors of the AIF in paragraph 1 of Box 14 since the Level 1 directive recognised that the AIFM’s duties are to the AIF, not to the AIF’s investors.

106. Several respondents requested to clarify directly in the text of Box 14 instead of under the relevant explanatory text that paragraph 1 of Box 14 shall apply to all AIFs while paragraphs 2 to 5 of Box 14 only apply to those types of AIFs which acquire or sell financial instruments or other assets for which best execution is relevant. Some asset managers further asked for the deletion of the words ‘or other assets that are’ after ‘financial instruments’ since further requirements are tailored to transactions in financial instruments, but not to other asset types like real estate, private equity, ships, etc.

107. Private equity and real estate representatives asked for modifying paragraph 6 of Box 14 to cover the fact that for investments in real estate or unlisted companies there is no execution venue at all.

ESMA's response: ESMA did not agree on the deletion of the reference to the interest of the AIF's investors from paragraph 1 of Box 14 since such reference reflects the provisions of Article 12(1)(b) of the AIFMD.

ESMA did not see any need to add in the content of Box 14 any reference to the fact that paragraphs 2 to 5 of Box 14 only apply to those types of AIFs which acquire or sell financial instruments or other assets for which best execution is relevant since such clarification is clearly provided under the relevant explanatory text and paragraph 6 clearly states that the requirements under paragraphs 2 to 5 of Box 14 do not apply whenever there is no choice of different execution venues (which shall obviously include the cases where there is no execution venue at all). Furthermore, ESMA decided not to delete the reference to the 'other assets' in paragraph 2 of Box 14 since it is intended to cover trading on assets like commodities for which best execution is relevant.

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

108. Several respondents requested to clarify directly in the text of Box 15 instead of under the relevant explanatory text that paragraph 1 of Box 15 shall apply to all AIFs while paragraphs 2 to 5 of Box 15 only apply to those types of AIFs which acquire or sell financial instruments or other assets for which best execution is relevant. Some asset managers further asked for the deletion of the words 'or other assets that are' after 'financial instruments' since further requirements are tailored to transactions in financial instruments, but not to other asset types like real estate, private equity, ships, etc.

109. Private equity and real estate representatives asked for modifying paragraph 5 of Box 15 to cover the fact that for investments in real estate or unlisted companies there is no execution venue at all.

ESMA's response: The same response provided above under Box 14 applies here mutatis mutandis.

Box 16 – Handling of orders – general principles

110. Some respondents requested to insert in the text of Box 16 the clarification included in the relevant explanatory text according to which Box 16 does not apply where the investment in assets is made after extensive negotiations on the terms of the agreement.

ESMA's response: ESMA did not consider appropriate to insert the provisions of the explanatory text in the content of Box 16 since these are an explanation for the advice given.

Box 17 – Aggregation and allocation of trading order

111. Some respondents requested to insert in the text of Box 17 the clarification included in the relevant explanatory text according to which Box 17 does not apply where the investment in assets is made after extensive negotiations on the terms of the agreement.

ESMA's response: The same response provided above under Box 16 applies here mutatis mutandis.

Box 18 – Inducements

112. Real estate representatives argued that a property company's income did not derive from its shareholders, in the way that the income of an external AIFM derived from the AIF it managed; thus, it would be very difficult to apply the proposed rules on inducements to property companies.

113. Some asset managers and institutional investors were of the view that the rules of Box 18 should apply to direct marketing by the AIFM, but they disagreed that they should apply to ‘indirect marketing’, as mentioned in the relevant explanatory text. The same asset managers considered that distribution through intermediaries should not constitute part of the fund management services as specified in Annex I to the AIFMD since external intermediaries who are not tied agents act in their own capacity and under their own responsibility. Furthermore, they mentioned that fees and commissions received by intermediaries as remuneration for their distribution services are already regulated by MiFID and therefore there is no need to require justification of the same payments in relation to collective portfolio management.
114. Other asset managers similarly asked not applying inducement rules on third party marketing and proposed that the requirement to ‘enhance the service’ in paragraph 1(b)(ii) was amended as regards marketing services by amending the wording to ‘must not impair the quality of the relevant service’. Private equity representatives requested to delete the reference to the enhancement of the quality of the service in paragraph 1(b)(ii) since if an AIFM received a payment from a third party, it would be difficult to see how that payment could enhance the quality of the service; in that case, the main question would be whether the payment gave rise to a conflict with obligations to the AIF or impaired compliance with the duty to act in the AIF’s best interests. Alternatively, the same private equity representatives and some institutional investors asked to include an adapted version of recital 39 of the MiFID implementing measures.
115. Furthermore, some asset managers considered disproportionate to restrict the receipt/payment of inducements since the AIFMD is aimed at AIFs marketed to professional investors. Therefore, it should be sufficient to rely upon the disclosure requirement under paragraph 1(b)(i) of Box 18; member states could impose stricter requirements for marketing to retail investors should they allow such marketing.
116. Private equity representatives considered essential that the reference to the ‘essential terms of the arrangements’ under paragraph 2 of Box 18 should be interpreted so that a generic disclosure covering the types of fee which may be received or paid should be sufficient.

ESMA’s response: ESMA decided not to introduce any change to the provisions of Box 18 to the extent considering appropriate to apply MiFID inducement rules to AIFM providing the service of collective portfolio management bearing in mind that those AIFM providing the service of individual portfolio management are already subject to such rules. This is obviously without prejudice of any future development of the MiFID rules; in such case, the rules set out in Box 18 should be aligned with the relevant developments.

Box 19 – Fair treatment by an AIFM

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

117. Several asset managers preferred option 1 in Box 19 since it provided more legal certainty leaving less room for divergent interpretations.
118. Other asset managers preferred option 2 in Box 19. Some of them preferred such option as long as such preferential terms may be made known to all other investors in an AIF. Others mentioned that preferential treatment should be permitted provided that it has been disclosed to other investors prior to investment in the funds.

119. A relevant number of respondents (including asset managers and institutional investors) considered that neither option 1 nor option 2 in Box 19 were preferable. They provided the following comments to support their opinion: some of them mentioned that the Level 1 text was sufficient and no further detail was required at Level 2; others were of the opinion that the proposal went beyond Level 1 (which only provided that preferential treatment is prohibited unless it is disclosed to the other investors); private equity representatives highlighted a series of potential issues related to the two options (in particular, the reference to an ‘overall material disadvantage to other investors’ left too much legal uncertainty); real estate representatives mentioned that the disclosure to investors could be made in general terms in the AIF’s prospectus or offering document provided that the details of any such preferential treatment are disclosed to those investors affected thereby prior to investment.

ESMA’s response: The European Commission requested to provide advice on the criteria to be used by the relevant competent authorities to assess whether AIFM comply with the obligations under Article 12(1) of the AIFMD, including treating all investors fairly.

Therefore, ESMA advice provided guidance on the definition of fair treatment. ESMA was of the view that the first paragraph of Article 12(1)(f) of the AIFMD provided the general principle of fair treatment of investors whereas the second paragraph provided an exception to the principle allowing a preferential treatment to the extent that it is disclosed to investors. However, such preferential treatment should be read in conjunction with the general principle; therefore, in principle any preferential treatment should not have a material disadvantage to other investors.

ESMA is aware of the fact that a principle of fair treatment is already contained in most, if not all, of the national regulatory frameworks under which competent authorities currently operate and decided that it was not appropriate to provide a maximum harmonising definition of fair treatment, in order to allow competent authorities to duly take into account the facts of a particular circumstance or case.

ESMA therefore indicated that fair treatment may include that no investor may obtain a preferential treatment that has a material overall disadvantage to other investors, but did not provide a definition which comprehensively defines fairness.

IV.III. Possible Implementing Measures on Conflicts of Interest

General comments

120. Institutional investors generally supported the approach taken as regards conflicts of interest, in particular because of the large consistency with the UCITS and MiFID Level 2 rules.

Box 20 – Types of conflicts of interest between the various actors as referred to in Article 14(1)

121. Some asset managers were of the view that the reference to the ‘relevant person’ (given the definition of such terms) would imply that the AIFM would have to take into consideration all type of conflicts of interest along the entire delegation chain and even internally to relevant persons.

122. Some respondents mentioned that the term ‘client’ was not defined and suggested replacing it with ‘any other contractual party’.

123. Hedge funds managers' representatives asked for limiting the requirement to identify conflicts to those which may be potentially be detrimental to investors or the relevant AIF.
124. Private equity representatives requested to clarify that paragraph 1(a) of Box 20 only covers compensation which gives rise to a conflict and to delete the words 'or its investors' to the extent the AIFM's duties are to the AIF and not to its investors. The same representatives proposed an amendment to the provisions of paragraphs 1(a),(b) and (c) to allow the disclosure of a conflict to the investors or the discussion with the investor advisory board. In addition, they asked the deletion of paragraph 1(d) of Box 20 since management activities may be carried out for different AIFs to the extent they do not give rise to a conflict.

ESMA's response: ESMA considered appropriate not to modify the text of Box 20 since it largely mirrored the relevant UCITS Level 2 provisions, thus achieving the appropriate level of horizontal consistency requested by the European Commission. In particular, ESMA did not take into account the requests made by the respondents of the consultation which were against the Level 1 text constraints (i.e. the request of limiting the requirement to identify conflicts to those which may be potentially be detrimental to investors or the relevant AIF and the claim that the AIFM's duties are to the AIF and not to its investors).

Box 21 – Conflicts of interest policy

125. Private equity representatives were of the opinion that it was important to keep the liberty of investors who wished that the AIFM was allowed to go ahead with a certain action despite the disclosure of a conflict of interest and proposed to amend paragraph 2(b) of Box 21 accordingly.
126. Several asset managers and institutional investors' representatives asked to ensure that an AIFM was not required to take on full liability for conflict management policies of third parties and to align the AIFMD provisions with those of MiFID and UCITS directive which provided that conflict identification obligations should apply where functions are delegated but not imply that an AIFM is fully liable for the acts of its delegate.

ESMA's response: ESMA considered appropriate not to modify the text of Box 21 since it largely mirrored the relevant UCITS Level 2 provisions. ESMA was of the opinion that the reference to the activities carried out by third parties was not in contrast with the provisions of MiFID and UCITS directive, but only provided a clarification on the entities which shall be covered by the reference to the activities carried out by or on behalf of AIFM, a similar reference being also included in the provisions of MiFID and UCITS directive.

Box 22 – Independence in conflicts management

127. Hedge funds managers' representatives supported the consistency in the relevant language with the equivalent provisions in MiFID and UCITS directive.
128. Some asset managers did not see the need for a separate supervision of the relevant person, as provided under paragraph 2(b) in Box 22.
129. Private equity representatives proposed the deletion of paragraph 2(c) of Box 22 as they believed it was redundant with the provisions of paragraphs 2(d) and 2(e).

ESMA's response: ESMA considered that no adequate evidence was provided by respondents for modifying the text of Box 22 which largely mirrored the relevant UCITS Level 2 provisions, thus achieving the appropriate level of horizontal consistency requested by the European Commission.

Box 23 – Record keeping of activities giving rise to detrimental conflicts of interest and way of disclosure of conflicts of interest

130. Some asset managers reiterated the comment made under Box 20 (i.e. alignment with the provisions of MiFID and the UCITS directive) and suggested the deletion of the reference to article 14(1) of the AIFMD in paragraph 2(a) of Box 23 since otherwise such obligation would cover any conflict of interest instead of those that are potentially detrimental to clients only.
131. Some of the aforementioned asset managers also asked modifying the requirements under paragraph 3 in Box 23 since in case of indirect distribution or of trading of parts of the AIF on a secondary market, the AIFM has no direct contact with the investors.
132. Several respondents proposed deleting paragraphs 3(a) and (b) since all professional investors have access to the internet and there should be no need to obtain investor consent to this method of disclosure.

ESMA's response: For the reasons mentioned above under Box 20, ESMA did not take into account the request of limiting the requirement to identify conflicts to those which may potentially be detrimental to investors or the relevant AIF.

ESMA considered that the Level 1 provisions did not make any distinction between direct and indirect distribution and, therefore, decided not to provide any limitation of the relevant requirements in case of indirect distribution.

ESMA agreed with the comment made by some of the respondents on the general availability of an internet access for professional investors and decided to delete the requirement imposing to the AIFM to ensure the existence of an evidence of such access, but saw merit in keeping the requirement that the investor shall consent to the provision of information via a website.

Box 24 – Strategies for the exercise of voting rights

133. Several asset managers welcomed the alignment of the provisions on the exercise of voting rights to those under the UCITS framework and some of them specifically supported the fact that the disclosure method under paragraph 3 of Box 24 was less onerous than under the UCITS directive.
134. Other respondents were of the opinion that the proposal under Box 24 was disproportionate and overly detailed and asked for the introduction of the proportionality principle for the application of the relevant provisions.

ESMA's response: ESMA decided not to take into account the claims for the application of the proportionality principle as regards the requirements under Box 24 since these are behavioural and not organisational requirements and should therefore apply whichever the size of the AIFM and the nature of its business are.

IV.II. Possible Implementing Measures on risk management

Box 25: Permanent risk management function

135. ESMA received several comments on Box 25 and the requirements concerning permanent risk management function.
136. It was asked that the reference to ‘effective’ risk management be linked to an element of proportionality in paragraph 1(a).
137. Other respondents were of the view that the requirements in Box 25 should take into account the nature, scale and complexity of the business and the AIFs managed by the AIFM and that paragraph 1(a) should include an element of materiality.

ESMA’s response: ESMA did not share the opinion of the respondents to the consultation that called either for the introduction of the principle of proportionality in paragraph 1(a) or in the entire Box 25. Indeed, provisions in Box 25 are general provisions that should be complied with by all AIFMs regardless the size of the structures or the type of AIFs managed.

Box 26: Risk management policy

138. Respondents were generally in agreement with ESMA’s proposal but made some specific drafting comments which were mostly concentrated on paragraph 1 of Box 26:
- According to some respondents, ‘reasonably’ should be added to the paragraph 1 in order to be in line with paragraph 1(a) of Box 25.
 - Other contributors were of the view that the paragraph should read as follow: ‘*AIFM shall establish implement...all the material relevant risk...might be exposed to*’
 - The following drafting for paragraph 1 was also proposed ‘*AIFM shall establish, implement and maintain an adequate and documented risk management policy which identifies ~~all the~~ relevant risks to which the AIF they manage are ~~or might be~~ exposed to.*’
139. Some stakeholders were of the view that a key element was that any disclosure to non-investors should be limited to regulators so that an AIFM’s know-how would not be required to be made available in uncontrolled way.
140. In relation to sub-paragraph 3(e), several respondents asked the focus be on ensuring that the safeguards are applied, rather than creating a requirement for more paper documenting compliance.
141. It was pointed out that most of the provisions were more relevant for AIFs that hold financial instruments rather physical property. In particular, it was stressed that in non-listed real estate funds, investment decision are made through an investment committee or similar committee or advisory boards that consider the risk involved prior to investment.
142. ESMA was also asked to use the notion of ‘independent’ risk management function rather than ‘separate’ risk management function in order to be aligned with the UCITS IV Directive.

ESMA's response: ESMA carefully analysed the comments received and did not feel appropriate to take on board the drafting suggestions made for paragraph 1(a) of Box 26. As regards the use of 'independent' risk management function instead 'separate' risk management function, ESMA believes preferable to stick to the Level 1 Directive that refers to separate function.

Box 27: Assessment, monitoring and review of the risk management policy

143. According to some respondents it was unclear how any assessment, monitoring and review should be documented, especially if no material change statement need to be made to an AIF's risk management policy.
144. For other stakeholders paragraph 2 should be aligned to Article 39(2) of the UCITS Directive and should read as follow: 'AIFM shall notify the competent authorities of their home Member State of any material changes to the risk management process'.
145. One contributor proposed that the notification of any material changes to the risk management policy from AIFMs to competent authorities should be requested by competent authorities themselves.

ESMA's response: ESMA was not in favour of amending the paragraph 2 of Box 27 as suggested by some respondents and this paragraph was in any event consistent with the UCITS requirement. According to ESMA, any material changes to the risk management system should be notified by AIFM and not requested by competent authorities that cannot be aware of such modifications.

Box 28: Measurement and management of risk

146. Respondents generally agreed with ESMA's proposal but some drafting suggestions to paragraphs 1(a), 3(a), 3(b), 3(c) and 3(e).
147. The amendments suggested to paragraph 1(a) were the following:
- The end of sentence '*including those sources of risk that the AIFM incurs on behalf of the AIF*' should be deleted in order to aligned with the UCITS IV Directive;
 - The words '*might be*' should be deleted; and
 - Paragraph 1(a) should read as follow '*... risks to which...might be reasonably exposed to...*'
148. The amendments suggested to paragraphs 3(a) were the following:
- The part of the paragraph which reads '*on the basis of sound and reliable data*' should be deleted in order to be aligned with the UCITS IV Directive.
149. The amendments proposed for paragraph 3(b) and 3(c) were:
- Both paragraphs should read '*conduct, where appropriate, periodic...*' to be more aligned with the UCITS IV Directive. According to some respondents this addition was required by the need to reflect differentiation of standards depending on the type of AIF, its investment strategy and portfolio of assets.

- Actions to be taken under paragraph 3 should be considered as ‘possible’ action.

150. On paragraph 3(e), the deletion of the reference to *anticipated* breaches was proposed.

151. Finally, some drafting suggestions were made to paragraph 2 to make clearer that actions under paragraph 3 shall be proportionate to the nature, scale and complexity of the AIF.

ESMA’s response: ESMA deemed it appropriate to delete in paragraph 1(a) the end of sentence referring to ‘including those sources of risk the AIFM incurs on behalf of the AIF’ and changed the paragraph accordingly. ESMA also agreed to delete in paragraphs 3(a) and 3(b) the reference to ‘*on the basis of sound and reliable data*’.

Box 29: Risk limits

152. One respondent believed that the entire Box 29 should be deleted as it was unnecessarily prescriptive and goes beyond what is required today by the MiFID.

153. According to several stakeholders paragraph 2 of Box 29 should read as follow: ‘The qualitative and quantitative risks limits for each AIF shall, at least, cover the following risks where relevant’.

154. The following drafting was also proposed for paragraph 2: ‘The qualitative... cover the following risks relevant for the specific type of AIF and its investment strategy which may include, for example, the following’.

ESMA’s response: ESMA disagreed with the suggestion to delete the Box 29 for the reason that the provisions were going beyond what is required today by the MiFID and did not modify the Box 29 in the final advice.

Box 30: Functional and hierarchical separation of the risk management function

155. As regards paragraph 1(a), some investment manager associations considered that the requirement that the risk management is not supervised by those responsible for the operating units was unlikely to be met by a large number of AIFMs, since both the risk management function and the portfolio management function may well have the same reporting lines. This comment was confirmed by a representative of the real estate industry that stressed that complete separation of operation and risk management would not be possible for non-listed real estate industry which requires that risks are managed at all levels of operation.

156. Concerning paragraph 1(e), several investment manager associations felt that this requirement would be very difficult to be met by small self-managed AIF and therefore asked for the separation to be made up to the senior management level. According to one of them, it should be sufficient for this requirement to be fulfilled if there was a direct reporting line by the head of the risk management function to the governing body.

157. Concerning the additional safeguards referred in paragraph 3, one investment manager association strongly believed that they should not be documented in the risk management policy but rather in the general management process of conflicts of interest.

158. For one contributor, the private equity and venture capital industry would not be able to have a separate risk management function and the proposed safeguards proposed by ESMA in case of no hierarchical separation were not appropriate. According to this contributor the ESMA's proposal was not tailored for the private equity and venture capital sector and safeguards envisaged in paragraph 3 of Box 30 would result in additional costs to be borne by investors. Finally, this respondent believed that there should be a possibility for AIFM to disclose to investors of non-segregation of conflicting duties if it is disproportionate to the nature, scale or complexity of the AIFM.

159. Concerning paragraph 3(d), a couple of investment manager association asked ESMA to provide more clarity on what could be considered as 'an independent external party'.

160. On paragraph 3(e), an investment manager association was of the view that there should be a small AIFM carve-out, notwithstanding the proportionality qualifier.

ESMA's response: Despite the comments made by respondents, ESMA felt the approach taken appropriate and did not deem necessary to modify the advice. Indeed, according to paragraph 2 of Box 30, competent authorities shall review the functional and hierarchical separation of the functions of risk management in accordance with the principle of proportionality. Therefore, this provision allows the general framework set by ESMA to be adapted to the nature, scale and complexity of the AIFM.

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

161. Respondents to the consultation generally believed that there was no need for additional safeguards.

ESMA's response: Based on the feedback received, ESMA does not recommend further safeguards so as to achieve the objective of an independent risk management function.

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

162. According to several respondents smaller funds, highly automated funds, exotic funds and private equity would have the most difficulty in demonstrating an independent risk management function.

163. It was stressed that non-real estate funds are organised in such a way that a process driven risk management approach is employed at all levels to achieve the goals of functionally and hierarchically separated risk management.

Possible Implementing Measures on liquidity management

Box 31: Liquidity management definition

164. According to some stakeholders gates should not be covered by the provisions regarding the application of ‘special arrangements’. On the same point, it was proposed to delete the reference to ‘gates’ in paragraph 9 of the explanatory text under Box 31 because there was no defined term of what constitutes a gate.

165. Besides some respondents suggested the use of ‘type of unit/share’ instead of ‘class of unit/share’ to avoid any confusion since the term ‘class’ could have a special meaning in some jurisdictions.

ESMA’s response: ESMA agreed with these comments and the reference to gates in the explanatory text under Box 31 has been deleted in the final advice and the wording of the definition modified to reflect the suggestion made by respondents.

Box 32: Liquidity management policies and procedures

166. For one asset manager representative, the references to ‘underlying obligations’ to ‘counterparties, creditors and other parties’ in paragraph 1 were to be too broad. This respondent further pointed out that the Directive itself did not contemplate the AIFM being obliged to have regard to the interests of such parties and, moreover, doing so may potentially place the AIFM in a position where the interests of those parties conflict with its obligations to act in the best interests of the AIF or its investors.

167. Some asset managers were of the view that paragraph 1 should include a reference to appropriateness and proportionality rather than the concept being reflected in the explanatory text in paragraph 12.

168. The same trade association was of the view that paragraph 3(b) should be removed because it should not be the responsibility of the AIFM to seek to ‘protect’ one category of investors in the AIF over another who may be perceived as more or less likely to exercise those redemption rights.

169. For some asset manager representatives, paragraph 3(c) should be deleted because it would impede asset managers from using certain highly-liquid underlying investments (such as overnight money market funds) where it would be impracticable for them to undertake the prescribed reviews.

170. It was also asked that the reference to ‘sufficient prominence’ in paragraph 3(e) be deleted and pointed out that this paragraph was not relevant in the context of closed-end funds.

171. For one respondent, paragraph 3(f) should be limited to ‘special arrangements’ rather than referring to ‘tools and arrangements’. As regards this paragraph, the same respondent was of the view the use of liquidity tools should also be allowed if they are not disclosed to investors but only under circumstances where it is the best interest of investors and subject to the competent authority approval.

172. According to several asset managers, the requirement in paragraph 3(h) to update the liquidity management and procedures for ‘any changes or new arrangements’ was overly burdensome and should be modified to foresee an update for ‘any material changes.’

173. According to one representative of the real-estate fund industry, non-listed real estate funds should not be required to maintain cash liquidity above the amounts needed to cover immediate costs, such as payroll and taxes. For non-listed real estate funds, it would be problematic for funds to comply with higher minimum cash liquidity.

ESMA's response: ESMA does not share respondents' views on paragraph 3(h) according to which the liquidity management and procedures should be updated only in the case of material change. However, ESMA agreed to delete the reference to 'sufficient prominence' in paragraph 3(e) as requested by some stakeholders. With regards paragraph 3(f), ESMA is of the view that it should not be limited to 'special arrangements' and that liquidity tools and arrangements should only be allowed if appropriate disclosures have been made to investors. However, ESMA felt it appropriate to soften paragraph 3(f) and to refer to tools and arrangements that 'may' be used instead of 'will be used'.

Box 33: Liquidity management limits and stress tests

174. As regard paragraph 1, one respondent was of the view that the provisions should be softened and provide some balancing between the strict liquidity requirements and the ability of the AIFM to take views on positions in investments that assume a certain degree of stability with the asset base of the AIF.

175. On the same paragraph, several investment manager associations believed that the last sentence should refer to 'what course of action if any' in order to better reflect paragraph 26 of the explanatory text according to which AIFM may determine that no action is required.

176. As regards paragraph 2(c), it was suggested that market risks should not be included in the assessment of liquidity risks, otherwise no clear result could be obtained regarding the liquidity of the AIF.

177. One respondent asked ESMA to clarify that paragraph 2(e) dealing with redemption policy was not relevant for closed-ended funds.

178. Concerning paragraph 3, many respondents believed that it would not be appropriate to require AIFM to 'act in the best interests of investors' as regard the outcome of the stress tests.

ESMA's response: ESMA carefully analysed the comments received during the consultation and did not deem it appropriate to take them on board and therefore did not modify the advice.

Box 34: Alignment of investment strategy, liquidity profile and redemption policy

179. See question 22 below.

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

180. Several investment manager associations believed that gates and side pockets should be considered as normal liquidity management tools, provided that investors are aware of their potential use by the

AIFM. Furthermore, according to them, the use of gates and side pockets should not be considered as the result of a failure of the AIFM's liquidity management process.

181. The representatives of non-listed real estate funds did not provide ESMA with specific comments on special arrangements with the justification that they were uncommon in non-listed real estate funds.

Q21: AIFMs which manage AIFs which are not closed ended (whether leveraged or not) are required to consider and put into effect any necessary tools and arrangements to manage such liquidity risks. ESMA's advice in relation to the use of tools and arrangements in both normal and exceptional circumstances combines a principles based approach with disclosure. Will this approach cause difficulties in practice which could impact the fair treatment of investors?

182. The majority of respondents answered this question via their comments on the relevant boxes.

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

183. According to several respondents, paragraph a) should be deleted. These respondents felt that the investment strategy, liquidity profile and redemption policy should be considered to be aligned when investors have the ability to redeem their investment in accordance with the AIF's redemption policy and obligation.

ESMA's response: Based on the limited number of comments on this issue, ESMA decided to keep the advice unchanged.

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

General comments

184. Some respondents (representing both asset managers and banks and other financial market participants) asked for harmonising some differences between the regime envisaged by the consultation paper on securitisation positions and the one under the CRD framework since, in principle, the same retention and due diligence requirements should apply to all types of EU regulated investors and that a different approach should be adopted only if and to the extent necessary. In particular, these respondents were of the opinion that the term 'tradable securities and other financial instruments based on repackaged loans' should be aligned more closely to the requirements under the CRD since it currently lacked any reference to tranching and appeared to limit the relevant securitisation underlying to loans.

185. Other respondents (representing institutional investors) were of the opinion that the requirements relating to securitisation were broadly comparable with those set out under the CRD.

186. Private equity and venture capital representatives did not have any comment to the possible implementing measures on investment in securitisation positions as they considered the relevant rules not applicable for private equity and venture capital.

ESMA's response: ESMA saw merit in the request to further align the advice with the relevant provisions of the CRD by replacing the references to 'tradable securities and other financial instruments based on repackaged loans' with references to the 'credit risk of a securitisation position' and modified the advice accordingly.

Box 35 – Requirements for retained interest

187. Some asset managers mentioned that the AIFM would in practice not be able to verify that the originator, sponsor or original lender retains a net economic interest of at least 5% and considered the requirements in Box 35 too burdensome and going beyond what is required under the CRD.

188. Some respondents mentioned that paragraphs 1 and 3 of Box 35 implied that it may be necessary to calculate or measure the retained interest at the date that the investment activity is undertaken and for the retained net economic interest to be maintained at a 5% level for the life of the transaction, whereas this was inconsistent with the CRD provisions as interpreted by CEBS. The same respondents added that if the originator did not retain as it indicated that it would, the AIFM or the UCITS should not be obliged to take corrective action and should instead be left to determine the appropriate course of action (if any), as presumably it would be naturally incentivised to do.

189. Some hedge funds managers' representatives asked for deleting the words 'and, if later, at the date of assumption' under paragraph 1 of Box 35 since such requirement was unclear and not imposed by the CRD provisions.

ESMA's response: ESMA acknowledged the concerns expressed by some respondents on the difficulties for the AIFM or the UCITS to check retained economic interest, but remained of the view that the overall horizontal regulatory approach contained a certain element of indirect regulation and that the parties to the securitisation transaction are obliged to retain in order for an AIFM (or UCITS respectively) to be 'entitled' to make the investment. However, ESMA felt appropriate to clarify that the AIFM should consider a corrective action whenever the retained net economic interest becomes less than 5% after the assumption of the exposure, but only to the extent that the interest did not decrease as a consequence of the contractual waterfall of the transaction.

7. Furthermore, ESMA saw merit in the request to delete the words 'and, if later, at the date of assumption' under paragraph 1 of Box 35 and modified the text accordingly.

Box 36 – Requirements for sponsors and originator credit institutions

190. Some respondents mentioned that the AIFM would in practice not be able to ensure that the sponsors or originators fulfil the requirements under Box 36 and considered these requirements too burdensome and going beyond what is required under the CRD. Other respondents noted that whereas Box 36 contemplates the imposition of requirements on AIFM and UCITS, the corresponding CRD provisions apply directly to credit institutions in their capacity as originator, sponsor or credit grantor.

191. Some hedge funds managers' representatives were of the opinion that where there is a public listing, the requirement of ensuring adequate standards of credit policy could be deemed to be given in the offering circular.

ESMA's response: For the reasons mentioned above under Box 35, ESMA did not consider appropriate to modify the requirements under Box 36. However, ESMA believed appropriate to clarify in the explanatory text that if the information required under Box 36 was given in the offering circular or the prospectus, if existing, the AIFM could rely on that information and would not be obliged to approach the sponsor, originator credit institution or original lender (as applicable).

Box 37 – Requirements for transparency and disclosure of retention

192. Some respondents noted that whereas Box 37 required AIFM and UCITS (as investors) to ensure that certain disclosures are made by sponsors, originators and original lenders, under the CRD a disclosure obligation was imposed directly on sponsor and originator credit institutions and the CEBS guidelines indicated that credit institution investors should not invest in securitisations unless they considered that they had access to the relevant information for the purposes of satisfying their due diligence requirements.

ESMA's response: For the reasons mentioned above under Box 35, ESMA did not consider appropriate to modify the requirements under Box 36.

Box 38 – Requirements for risk and liquidity management

193. Some asset managers were of the opinion that Box 38 reflected the general principles of risk management and, therefore, should either be deleted or tied in with the relevant implementing provisions on risk management.

ESMA's response: ESMA considered appropriate to keep Box 38 to the extent that, whereas partially based on the general provisions of Article 15(2) of the AIFMD, it put a particular focus on the ALM, concentration and investment risk.

Box 39 – Requirements for monitoring procedures

194. Some asset managers suggested modifying the last sentence in Box 39 since 'Issuer name and credit quality' are no categories of securitisation tranches.

195. Some hedge funds managers' representatives questioned the feasibility of the compliance with the relevant requirement for smaller AIF.

ESMA's response: Given the limited amount of feedback received, ESMA understood that the content of the box was generally agreed by stakeholders and decided not to introduce any amendment to its content.

Box 40 – Requirements for stress tests

196. Some asset managers suggested linking the provisions in Box 40 to the general requirements for risk measurement and stress testing proposed in Box 28 in order to ensure a consistent approach to the AIF risk management.

ESMA's response: Given the limited amount of feedback received, ESMA understood that the content of the box was generally agreed by stakeholders and decided not to introduce any amendment to its content.

Box 41 – Requirements for formal policies, procedures and reporting

197. A few respondents asked for clarifications on the sanctions, if any, for failure to comply with the relevant requirements.

ESMA's response: Given the limited amount of feedback received, ESMA understood that the content of the box was generally agreed by stakeholders and decided not to introduce any amendment to its content.

Box 42 – Introduction of new underlying exposures to existing securitisations

198. Some asset managers called for the introduction of grandfathering provisions for investments in positions between 1 January 2011 and the entry into force of the implementing measures of the AIFMD and suggested that a transitional period should be granted to AIFM for dispositions of investments held by AIF at the entry into force of the new rules.

199. Some hedge funds managers' representatives were of the opinion that it would not be appropriate to follow the CRD approach by introducing an equivalent 2014 deadline and it would be preferable not to impose the 2014 provisions on AIFs so that AIFs would not be forced to sell their securitisations in case they do not find an appropriate person to retain the 5% interest, thus helping to maintain price stability and liquidity.

200. The same hedge funds managers' representatives asked for the introduction of a clear provision (similar to CRD provisions) stating that all the requirements, including the qualitative requirements mentioned under article 17(b) of the AIFMD, are to be applied only to securitisations issued after 1 January 2011.

ESMA's response: ESMA did not consider appropriate to introduce any amendment to the grandfathering provisions of Box 42 to the extent that these are aligned on the relevant CRD provisions and the CEIOPS' advice and should be interpreted in the light of the CEBS Guidelines for interpreting the respective grandfathering provisions of the CRD, thus ensuring cross-sectorial consistency.

Box 43 – Investments by UCITS

201. Respondents expressed a general agreement on the alignment of the UCITS requirements with those set out for AIFM.

ESMA's response: In light of the general consensus received from the respondents to the consultation, ESMA decided not to introduce any amendment to the content of Box 43.

IV.VII. Possible Implementing Measures on Organisational Requirements

General comments

202. Some real estate representatives considered inefficient to apply additional organisational requirements under the AIFMD implementing measures to listed property companies which are already sub-

ject to extensive EU and national rules and best practice guidance in relation to corporate governance, reporting, transparency and disclosure.

203. Other real estate representatives did not have any comments on the rules on the organisational requirements since industry practices are largely consistent with the foreseen requirements.

ESMA's response: Given the mixed views received from respondents, ESMA considered that there was no evidence that the organisational requirements set out in the advice (broadly reflecting the UCITS and MiFID Level 2 measures) were inappropriate.

Box 44 – General requirements on procedures and organisation

204. Several asset managers asked to clarify that the proportionality principle should be employed in applying all the implementing measures in Box 44, not only those at paragraph 1 of the Box 44.

ESMA's response: ESMA decided not to introduce any amendment to the provisions of Box 44 which introduced the proportionality principle in a manner which was consistent with the approach taken under the UCITS and MiFID Level 2 measures.

Box 45 – Resources

205. Private equity representatives welcomed the introduction of the proportionality principle within the provisions of Box 45.

206. With reference to paragraph 3 of Box 45, some asset managers asked for clarifying that smaller AIFMs should be allowed to have less extensive human and technical resources than those required to larger AIFMs.

ESMA's response: Given the feedback received from the respondents to the consultation, ESMA decided not to introduce any amendment to the content of Box 45.

Box 46 – Electronic data processing

207. With reference to the requirement for 'appropriate arrangements' at paragraph 1 of Box 46, several asset managers asked for the introduction of a reference to the proportionality principle.

208. Private equity and venture capital representatives asked to replace the reference to 'electronic systems' with a more generic reference to 'systems' as private equity and venture capital AIFM usually record transactions in paper form and to exclude any record obligation whenever the transaction is managed by a third party.

ESMA's response: ESMA decided not to introduce any amendment to the provisions of Box 46 considering that the approach taken was consistent with the one taken under the UCITS and MiFID Level 2 measures.

Box 47 – Accounting procedures

209. Several asset managers called for the insertion of a reference to the proportionality principle.

210. Some hedge funds managers' representatives mentioned that Box 47 seemed to imply that the AIFM would maintain the accounts, which is incorrect.
211. Private equity and venture capital representatives suggested clarifying that AIFM should have the flexibility to determine the accounting standards used for an AIF (e.g. U.S. GAAP and non-statutory accounting standards) without having to prepare two sets of accounts for each investor base (i.e. one consolidating and one non-consolidating the AIFM's fund or portfolio companies in the presentation of the accounts).

ESMA's response: ESMA decided not to introduce any amendment to the provisions of Box 47 considering that the approach taken was consistent with the one adopted under the UCITS and MiFID Level 2 measures. In particular, ESMA wishes to clarify that Article 22(3) of the AIFMD provides that the AIF's annual report shall be prepared in accordance with the accounting standards of the home Member State of the AIF or in accordance with the accounting standards of the third country where the AIF is established and with the accounting rules laid down in the AIF rules or instruments of incorporation. Therefore, the accounting standards to be used shall be determined according to the aforementioned Level 1 rules.

Box 48 – Control by senior management and supervisory function

212. Private equity and venture capital representatives welcomed the fact that the text of Box 48 is neutral on the identity of the individuals or body which performs the senior management and supervisory functions of the AIFM. They also requested the insertion of a reference to the proportionality principle in Box 48.
213. Some asset managers mentioned that the requirement to have the senior management approval and review was too strict and suggest introducing the possibility to also have approval and review by middle management.
214. Certain hedge funds managers' representatives mentioned that the text should be tailored to provide for other legal forms, such as limited liability partnerships, where there are no directors, but partners.
215. The same hedge funds managers' representatives asked for (i) deleting the reference to non-executive directors from paragraph 12 of the relevant explanatory text since they should not have this role (as non-executive) and (ii) for deleting paragraph 2(b) of Box 48 or alternatively amending it for taking into consideration the fact that the investment strategies or policies may not be set by the manager but at the level of the AIF.

ESMA's response: ESMA decided to align more closely the provisions of Box 48 with the ones of the UCITS Level 2 measures and thus saw merit in deleting the reference to the AIFM's senior management approval of the investment strategies of each managed AIF and in deleting the distinction between national systems which provide for the dual board system and national system which do not provide for such a system for the purposes of the definition of the term 'supervisory function' in the explanatory text. ESMA did not consider appropriate to introduce the remaining amendments suggested by the respondents mainly since they would not be in line with the corresponding UCITS Level 2 measures.

Box 49 – Permanent compliance function

216. Several respondents (including asset managers and institutional investors) asked for the introduction in the text of Box 49 of the clarification (included in the explanatory text only – paragraph 15) that it was not requested to establish an independent compliance unit if this would be disproportionate for the AIFM.

ESMA's response: ESMA did not consider necessary to insert a specific reference to the proportionality principle in the text of the box to the extent that the explanatory text already included a specific reference to such principle and decided to keep the text of the box which reflected the corresponding UCITS Level 2 measures.

Box 50 – Permanent internal audit function

217. Some asset managers and institutional investors recommended the inclusion of an option to outsource the permanent internal audit function.

218. Some hedge funds managers' representatives suggested amending paragraph 1 of Box 50 to make clear that, as mentioned in the relevant explanatory text, in case the separation and independence of the audit function from other functions is disproportionate, the audit function shall be carried out by another business unit of the AIFM.

219. One respondent asked to delete Box 50 since its provisions were unnecessary and too detailed and the need for proper processes to review an AIFM's systems, internal control mechanisms and arrangements was already satisfied by the compliance function covered by Box 49.

ESMA's response: To the extent that reference to the proportionality principle was already made in the text of Box 50, ESMA did not consider necessary to insert any further amendment to the content of this box nor to delete it since it was not unnecessary and reflected the corresponding UCITS Level 2 measures.

Box 51 – Personal transactions

220. Some respondents were concerned by the fact that due to the definition of 'relevant person' more types of persons would fall under the scope of the personal transactions rules and proposed to limit the scope of the rules.

221. Real estate representatives mentioned that it was usual that managers and other relevant persons participated in in-house non-tradable closed-ended funds and felt the ban of such kind of investments as unsatisfactory since it should be sufficient simply to advise other investors of such participating persons. In case the current proposal was kept, the said respondents asked to clarify that existing investments held by the relevant persons in non-tradable closed-ended funds were not covered by the scope of this provision, given the grand-fathering clause for non-tradable closed-ended funds under article 61(3) of the AIFMD.

222. Private equity representatives asked to delete the reference to 'other assets' under paragraph 1(b) of Box 51 since this would involve applying public market standards to private investments; such reference could be replaced with a reference to 'partnership interests' which in a number of jurisdictions are already treated as included in financial instruments.

223. The same private equity representatives suggested introducing a system that notifies individuals of their obligations in respect of personal transactions, coupled with a self-certification system in respect of such transactions (paragraph 2(a) and (b) of Box 51), and asked to clarify that for the requirements of Box 51 the proportionality principle shall apply.

224. Some asset managers suggested clarifying in paragraph 4 of Box 51 that the obligation should only apply if the assets are relevant to the concerned AIF.

ESMA's response: ESMA acknowledged the comments made by the respondents and was of the opinion that there was no adequate rationale for diverging from the relevant UCITS Level 2 measures on personal transactions other than for including not only personal transactions with financial instruments but also personal transactions with other assets. Therefore, ESMA decided to keep the text of the box without amendments.

Box 52 – Recording of portfolio transactions

225. Hedge funds managers' representatives considered the proposal as a sensible adaptation of the UCITS directive requirements.

226. Private equity and venture capital representatives mentioned that the proposed recording provisions were inapplicable and irrelevant to private equity and venture capital funds and therefore suggested to tailor them by making a distinction between transactions which take place on an execution venue and transactions which take place outside an execution venue.

227. Some respondents pointed out that Box 52 did not take into account the variety of AIFM that may be required to keep records or the type of assets which they are dealing in (e.g. a self-managed AIF managing its own money on behalf of its own shareholders) and suggested that paragraph 2 should be made optional and the list under paragraph 2(a) to (i) should be indicative only.

228. Some asset managers and institutional investors' representatives asked for the insertion of a reference to the proportionality principle in Box 52.

ESMA's response: ESMA considered appropriate to make a distinction in the recording requirements depending on the type of assets and saw merit in the request to make a distinction between transactions which take place on an execution venue and transactions which take place outside an execution venue. Therefore, ESMA decided to introduce the relevant distinction and to provide for appropriately differentiated recording requirements for transactions which take place outside an execution venue.

ESMA did not consider appropriate to introduce the proportionality principle within the provisions of Box 52 since, whereas a differentiation based on the type of assets appeared adequate, the recording obligations should apply whichever the size of the AIFM and the nature of its business are.

Box 53 – Recording of subscription and redemption orders

229. Some stakeholders pointed out that the requirements were only applicable to the direct distribution by the AIF and that different solutions regarding the recording of orders should be permitted in case of indirect distribution or trading on a secondary market. Similarly, private equity and venture capital

representatives pointed out that the requirements of Box 53 were designated for traded and liquid open-ended funds and are irrelevant in the context of closed-ended funds.

230. The same private equity and venture capital representatives asked for the insertion of a reference to the proportionality principle in Box 53.

231. Some hedge funds managers' representatives were of the opinion that paragraph 2(i) of Box 53 should refer to drawn and undrawn commitments and the words 'and paid' should be deleted accordingly.

ESMA's response: ESMA acknowledged the comments received from respondents arguing that the recording requirements were not relevant for indirect distribution or trading on a secondary market as well as for closed-ended funds. However, ESMA did not consider necessary to introduce any amendment to the content of the box to the extent that the recording obligations should apply to any kind of funds as far as an AIF subscription and, where relevant, redemption occurred.

ESMA did not consider appropriate to introduce the proportionality principle within the provisions of Box 53 since the recording obligations should apply whichever the size of the AIFM and the nature of its business are.

The reference to the 'amount of capital committed and paid' was inserted to cover private equity AIF where there is no subscription price for each unit, but rather a commitment to invest. ESMA considered that no adequate evidence was provided by the respondents asking to include undrawn commitments in the recording obligations and, therefore, decided not to amend the box on this point.

Box 54 – Recordkeeping requirements

232. Hedge funds managers' representatives considered the proposal as a sensible adaptation of the UCITS directive requirements.

233. Some stakeholders pointed out that the requirements were only applicable to the direct distribution by the AIF and that different solutions regarding the recordkeeping of orders should be permitted in case of indirect distribution or trading on a secondary market.

234. Some private equity and venture capital representatives asked for the insertion of a reference to the proportionality principle in Box 54, noting, in particular, that the requirements in paragraph 3 are irrelevant to a typical private equity or venture capital AIFM or AIF.

ESMA's response: ESMA acknowledged the comments received from respondents arguing that the recordkeeping requirements were not relevant for indirect distribution or trading on a secondary market. However, for the same reasons mentioned under Box 53 above, ESMA did not consider necessary to introduce any amendment to the content of the box.

ESMA did not consider appropriate to introduce the proportionality principle within the provisions of Box 54 since the recordkeeping obligations should apply whichever the size of the AIFM and the nature of its business are.

Q23: Should a requirement for complaints handling be included for situations where an individual portfolio manager invests in an AIF on behalf of a retail client?

235. The large majority of respondents did not consider that a requirement for complaints handling should be included for situations where an individual portfolio manager invested in an AIF on behalf of a retail client. Some of the respondents explained that adequate procedures for complaint handling were already provided for by MiFID provisions which apply to the relationship between the AIF and its investors.

ESMA's response: In light of the feedback received from respondents who clearly rejected the idea of introducing a requirement for complaints handling for situations where an individual portfolio manager invested in an AIF on behalf of a retail client, ESMA took the decision not to introduce such requirement.

IV.VIII. Possible Implementing Measures on Valuation

General comments

236. There was a general agreement on the valuation framework set out in the proposal and some institutional investors specifically welcomed the fact that it can be adapted to the specific characteristics of the diverse type of assets in which an AIF may invest.

Box 55 – Policies and procedures for the valuation of the assets of the AIF

237. Some respondents were concerned by the fact that paragraph 2 of Box 55 could be read to require a single approach to the valuation of a specific legal type of asset in all circumstances by the AIFM (whereas AIFMs may use a number of different methods of valuation of the AIFs' assets) and asked to modify such paragraph as follows: 'An AIFM shall not invest in a particular type of asset for the first time unless appropriate valuation methodologies have been identified'.

238. Some private equity and venture capital representatives asked to replace the word 'Where' at the beginning of paragraphs 4 and 5 of Box 55 with the words 'To the extent that' in order to reflect not only the fact (already covered by paragraph 11 of the explanatory text) that an AIFM may appoint several external valuers, but also that an AIFM may opt for a combination of approaches (internal and external valuation of AIF assets).

239. One stakeholder asked to modify paragraph 11 of the explanatory text under Box 55 in order to provide that the external manager may be appointed by the AIF when there is actual internal management and not 'where the legal form of the AIF permits an internal management' as it is currently foreseen.

240. Real estate representatives expressed a general agreement on the rules set out in the box.

ESMA's response: ESMA agreed on the necessity to clarify that the AIFM was not required to adopt a single approach to the valuation of a specific legal type of asset in all circumstances, but instead it shall not invest in a particular type of asset for the first time unless appropriate valuation methodologies have been identified.

Given the feedback received, ESMA felt also appropriate to specify that the external manager may be appointed by the AIF when there is actual internal management.

ESMA did not see any merit in replacing the word ‘Where’ at the beginning of paragraphs 4 and 5 of Box 55 with the words ‘To the extent that’.

Box 56 – Models used to value assets

241. Some respondents asked to clarify that the person validating the model according to paragraph 2 of Box 56 might be an internal or external person.

ESMA’s response: ESMA saw merit in providing the clarification requested by the respondents and modified the explanatory text accordingly.

Box 57 – Consistent application of the valuation methodologies

242. While some respondents supported the proposal noting only that there might legitimately be considerable variation between valuation policies and procedures used in relation to several AIFs managed by the same AIFM, other respondents considered burdensome and not feasible that policies and procedures should be applied across all AIF having the same AIFM (in particular because AIFM often manage AIF located in different jurisdictions which are subject to the local valuation rules and requirements) and that valuation sources and rules should remain consistent over time. Therefore, some of the respondents suggested deleting paragraph 2 of Box 57 or alternatively (i) to insert the clarification currently in the explanatory text according to which the application of consistency should take into account the existence of different external valuers and (ii) to allow for different accounting standards and different pricing sources to be applied across different AIFs being managed.

ESMA’s response: Without any prejudice of the requirement of ensuring a consistent application of valuation methodologies which shall remain applicable in its entirety, ESMA recognised the opportunity to delete the second sentence under paragraph 2 of Box 57 requiring that the policies and procedures shall be applied across all AIF having the same AIFM.

Box 58 – Periodic review of the appropriateness of the policies and procedures including the valuation methodologies

243. Several respondents supported the content of Box 58 and the relevant explanatory text.

244. Some private equity and venture capital representatives suggested amending the wording of the Box in order to replace the annual review requirement with some provisions reflecting the best practice of the private equity/venture capital sector in relation with the material changes to valuation policies and procedures.

ESMA’s response: ESMA did not see the merit of amending the frequency of the policies and procedures’ review and decided not to make any amendment to the content of the box, also considering the general support it received.

Box 59 – Review of individual values

245. Most of respondents did not express any concern in relation to the requirements of Box 59.

246. Some respondents considered the requirements of Box 59 excessively burdensome, in particular considering that, if an external valuer was appointed, the AIFM should be able to rely on the values provided by the valuer, in line with the text of the AIFMD which did not require any further clarification.

tion. They asked some consequent amendments and deletions within the Box to address their concerns.

247. A private equity and venture capital association proposed some amendments to the content of Box 59 in order to clarify that the AIFM should not be required to undertake a methodical review of its (or its external valuer's) conclusions with respect to valuation for each asset, but such review should be limited to the occurrence of changing facts or circumstances.

248. One stakeholder asked to clarify that the comment on the valuation of illiquid assets under paragraph 18 of the explanatory text did not refer to all 'other assets' as defined under article 21(8)(b) of the AIFMD and that valuation of physical assets such as real estate, ships and aircrafts are by no means more subject to error in spite of the illiquid nature of the assets.

ESMA's response: Given that the majority of respondents did not raise any specific concern as regards the requirements of Box 59, ESMA felt appropriate to keep the requirements of the box substantially unchanged, but, in the light of the feedback received, saw merit in clarifying that the AIFM has to document by type of assets the way the appropriateness and fairness of the individual values is assessed, meaning that it has not to mandatorily perform its own assessment.

Box 60 – Calculation of net asset value per unit or share

249. A couple of private equity and venture capital and real estate associations asked to replace the word 'The' at the beginning of each paragraph of Box 60 with the words 'Where relevant, the', in order to reflect the fact that private equity/venture capital or real estate AIF structured as limited partnerships do not issue shares or units of the sort contemplated by the Level 1 directive and there is no issue or subscription or redemption of shares in case of draw downs or distribution of realisation proceeds or other income.

250. An institutional investor and an asset managers' association mentioned that, according to article 19(4) and (7) of the AIFMD, the governing body of an AIF that has appointed an external AIFM may also appoint an external valuer and suggested to amend paragraph 23 of the explanatory text accordingly (the text read as follows: 'The AIFM is always responsible for ... where appropriate the appointment of an external valuer').

251. Several respondents agreed with the statement in paragraph 24 of the explanatory text under Box 60, whereas one stakeholder considered that the statement in paragraph 24 of the explanatory text according to which a third party which calculates the net asset value of an AIF based on values obtained from the AIFM, pricing sources or values obtained from an external valuer is not an external valuer, was not in line with the provisions of the Level 1 directive.

ESMA's response: ESMA did not consider appropriate to modify the text of paragraph 1 of Box 60 to take into account the comment made by the private equity and venture capital and real estate representatives, but clarified that the requirement applies for each issue or subscription or redemption or cancellation of units or shares. The requirements would therefore not apply in case such activities are not carried out.

ESMA decided not to amend paragraph 23 of the explanatory text since the reference to the appointment of the external valuer by the AIFM did not foresee an appointment by the AIFM in all circumstances but only 'where appropriate'.

ESMA did not agree with the comment made by one respondent and considered that the statement in paragraph 24 of the explanatory text under Box 60 according to which a third party which calculates the net asset value of an AIF based on values obtained from the AIFM, pricing sources or values obtained from an external valuer is not an external valuer, was in line with the provisions of the Level 1 directive. However, ESMA saw merit in clarifying that the valuations for individual assets that the third party entity carrying out the calculation of the net asset value for an AIF shall not provide in order not to be considered an external valuer include those requiring subjective judgement.

Box 61 – Professional guarantees

252. The majority of respondents welcomed the proposal in Box 61.

253. A depositaries' association was of the opinion that the reference to the fact that the professional guarantees should include evidence of the valuer's qualification and capability to perform the valuation function left too much room for a divergent approach by Member States.

254. The same association mentioned that in the consultation paper there was not mention of the possibility to appoint the depository as an external valuer and asked to clarify whether in case of such an appointment the depository would have to provide the same professional guarantees.

255. Finally, the said association was concerned by the provision of the Level 1 directive according to which the appointed external valuer may not delegate the valuation function to a third party (article 19(6) of the AIFMD): if the external valuer is the depository such provision would be problematic since the valuation of some asset classes is performed by the dedicated entities and/or department of the depository group.

ESMA's response: Given the general support received from respondents, ESMA did not feel appropriate to amend the content of Box 61 to introduce any further clarification.

ESMA believes that the professional guarantees requirements should apply to any appointed external valuer. As for the impossibility for the external valuer to delegate the valuation function to a third party, ESMA recalls that, as pointed out by the concerned respondent, the prohibition comes from the Level 1 provisions.

Box 62 – Frequency of valuation carried out by open-ended funds

256. Respondents generally supported the content of Box 62. A couple of respondents asked to clarify in Box 62 that it applies to open-ended funds only.

ESMA's response: ESMA decided not to include any further clarification in the content of the Box, given that its title clearly referred to open-ended funds.

IV. IX. Possible Implementing Measures on Delegation

Box 63 – Delegation

257. Several respondents requested more precise guidance on which functions should be considered 'critical and important' and which should be considered 'supporting tasks'. Some of them requested the inclusion of paragraphs 9 and 11 of the explanatory text under Box 63 directly into the text of Box 63, in particular since they provided a crucial interpretation of the term 'critical and important func-

tions'. Other respondents asked for the introduction of the words '(other than supporting tasks)' after 'functions' in the last line of paragraph 1 of Box 63 and for clarifying (without prejudice to the provisions on valuation under article 19 of the AIFMD) that all the functions set out in paragraph 2 of Annex I of the AIFMD constitute 'supporting tasks' to which the provisions of article 20 of the AIFMD do not apply. A couple of stakeholders recommended clearly designating IT suppliers and similar support as providers of 'supporting tasks' not subject to the delegation rules.

258. There were some comments highlighting that the services mentioned in Box 63 did not involve delegating any function since they did not relate to a function which the AIFM has responsibility for in the first place and asking to modify paragraph 3(a) of Box 63 to specify that the list of functions which should not be considered as critical or important for the purposes of Box 63 is not exhaustive and to include into such list a reference to the provision of accounting, audit, marketing and corporate finance, tax and financial advice.

259. One respondent requested to clarify that article 20 of the AIFMD should not apply where the AIFM has directly appointed someone other than the AIFM to perform a particular task.

ESMA's response: Notwithstanding certain of the comments received from the respondents, ESMA decided not to modify the content of Box 63 since it considered that Box 63 and its explanatory text provided sufficiently detailed rules to determine which functions shall be regarded as 'critical and important' and which as 'supporting tasks'. In particular, ESMA did not include in the text of the Box the list of arrangement or activities which are unlikely to constitute delegation or, if they constitute delegation, are unlikely to constitute delegation of 'critical and important' functions since, given the nature of such indicative list, ESMA felt more appropriate to keep it in the explanatory text. Furthermore, ESMA disagreed with the request to include IT support with the 'supporting tasks' since such support may be crucial for the activities of the AIFM.

Finally, ESMA believes that the content of Box 63 clearly states that the delegation rules should apply in case of delegation of a task which would otherwise be undertaken by the AIFM (i.e. not task which the AIFM is not responsible for).

Box 64 – General principles

260. Several respondents appreciated the content of Box 64.

261. An investment managers' association suggested deleting the words 'in particular' from paragraph 1 of Box 64 and asked for aligning the provisions with those under the MiFID framework by requiring AIFM only to take necessary steps to ensure that the conditions are met. An institutional investor's association similarly asked to clarify that AIFMs are required to 'make reasonable efforts' with regard to the general principles.

262. One respondent suggested replacing the word 'guaranteed' with the word 'maintained' (which better describes the outcome the AIFM should secure) under paragraph 1(f) of Box 64.

263. Another respondent suggested either deleting the first sentence of paragraph 1(e) of Box 64 or cross-referring to the provisions relating to letter box entities under Box 73 since there is an overlap between these provisions.

264. A couple of stakeholders asked to clarify under paragraph 1(h) of Box 64 that the delegate should keep some discretion in implementing the investment policy, notwithstanding the instructions of the AIFM.

ESMA's response: Given the general support on the content of Box 64, ESMA did not agree with the requests to amend it, in particular with those asking to align it with the provisions under the MiFID framework since it believed that the provisions of the box were already aligned with those of Article 14 of MiFID Level 2. However, for the reasons mentioned by the relevant respondent, ESMA saw merit in the suggestion to replace the word 'guaranteed' with the word 'maintained' under paragraph 1(f) of Box 64.

Box 65 – Objective Reasons

Q24: Do you prefer Option 1 or Option 2 in Box 65? Please provide reasons for your view.

265. The majority of respondents preferred option 1 in Box 65. Some of them mentioned that option 1 provided a general rule which might be applied in a flexible manner and was more in line with the UCITS approach. A respondent added that it would be misleading to state only few examples of objective reasons which would give no guidance but rather be confusing. Another respondent was afraid that national supervisors could regard option 2 as an exhaustive list of legitimate objective reasons for delegation.

266. Several respondents preferred option 2 in Box 65 since it set out a number of the key reasons why the delegation might be used while recognising that there might be other satisfactory justifications for delegation.

267. A relevant number of respondents considered that option 1 and option 2 in Box 65 could be combined (some of them suggested this solution as an alternative to the adoption of option 2): option 2 could provide an indicative non-exhaustive list of rationales to qualify as objective reason for delegation under option 1.

ESMA's response: Given the mixed views expressed by the respondents to the consultation, ESMA decided to opt for the combination of option 1 and option 2 in Box 65 which represented a solution taking into due account the feedback received and should be satisfactory for the achievement of the relevant regulatory purposes..

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

268. An asset managers' association disagreed with the requirements of Box 66 and asked for a closer alignment with the MiFID and UCITS relevant provisions.

269. A private equity representative mentioned that the list of requirements under Box 66 should be an indicative list and that some proportionality should be introduced in order to consider the size, scale and nature of the AIFM versus the identity of the service provider.

270. A respondent asked for providing explicitly that, whenever the AIFM delegates its functions to one of the entities listed in Box 67, the requirements under paragraphs 2 to 4 in Box 66 shall be deemed to be fulfilled. Other respondents mentioned that the AIFM should be able to rely on the professional status of the delegate in circumstances where it is regulated within the EU or a third country. Similarly, one stakeholder was of the opinion that where the delegate is an authorised firm, the AIFM should

be able to rely on the authorisation and perform the additional checks that it believe necessary depending on the specific circumstance of the case and the functions delegated.

271. An asset managers' association suggested deleting the reference to 'theoretical knowledge' under paragraph 3 of Box 66 as unclear.

272. Several respondents asked to introduce some proportionality as for the requirement under paragraph 4 instead of introducing an absolute prohibition in case of criminal offences, judicial proceedings or administrative sanctions. Some of them asked to allow the AIFM to rely upon a confirmation of the delegate concerning the absence of negative records relevant to the performance of the delegated tasks. Other respondents asked for introducing into the Level 2 measures the text of paragraph 29 of the relevant explanatory text. It was also asked to amend paragraph 4 to allow to the appointed legal person to contractually guarantee the reliability of the staff acting on its behalf.

ESMA's response: Given the feedback received from the respondents to the consultation, ESMA decided to modify the content of the box to provide that the list of checks to be performed by the AIFM in relation to the sufficient resources and experience and sufficiently good repute of the delegate represents an indicative list.

273. ESMA considered the reference to 'theoretical knowledge' under paragraph 3 of Box 66 as sufficiently clear and did not see merit in deleting it.

274. ESMA agreed on the fact that whenever the delegate is a regulated entity, the AIFM may assume that the persons who effectively conduct the business of the delegate are of sufficiently good repute. However, ESMA decided to limit such presumption to entity regulated within the EU and that the presumption shall not cover the requirements relating to the sufficient resources of the delegate and the sufficient experience of the persons who effectively conduct the business of the delegate: these requirements should be checked by the AIFM on a case by case basis.

275. ESMA decided to modify the requirements of paragraph 4 in order not to introduce an absolute prohibition in case of criminal offences, judicial proceedings or administrative sanctions.

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

276. Several respondents welcomed the proposal in Box 67.

277. An asset managers' association proposed to include in the list also other institutions to the extent they are subject to similar regulatory requirements under national laws (e.g. German 'Anlageverwaltung' is subject to regulation similar to a portfolio manager under MiFID).

278. One respondent considered that the possibility for management companies to delegate to credit institutions could lead to regulatory arbitrage and that delegation should be allowed to entities authorised for investment management.

ESMA's response: Given the general support received on the proposal, ESMA did not consider appropriate to broaden or limit the scope of Box 67.

Box 68 – A delegation would prevent the effective supervision of the AIFM, or the AIFM from acting, or the AIF from being managed, in the best interest of its investors in particular under the following circumstances:

279. One respondent asked to refer to the ‘AIF’ only in paragraph 2 of Box 68 instead of to the ‘AIFM or the investors of the AIF’ since the Level 1 directive recognised that the AIFM’s duties are to the AIF, not to the AIF’s investors.

ESMA’s response: ESMA did not agree with the proposal since the reference to the best interests of the AIF’s investors was explicitly made in Article 20(1)(e) of the AIFMD.

Box 69 – Sub-delegation – General principles

280. Respondents generally agreed with the content of Box 69.

ESMA’s response: Given the support received, ESMA kept the content of Box 68 without any amendment.

Box 70 – Type of evidence necessary for an AIFM to demonstrate its consent to sub-delegation

281. Respondents generally agreed with the content of Box 70.

282. Some stakeholders mentioned that the requirement to demonstrate the consent of the AIFM to each sub-delegation in writing seemed to be unnecessary if the general delegation agreement is clear with regards to the permitted sub-delegation.

ESMA’s response: Given the general support received, ESMA kept the requirement to evidence the AIFM’s consent to each sub-delegation in writing.

Box 71 – Criteria to be taken into account when considering whether a delegation/ sub-delegation would result in a material conflict of interest with the AIFM or the investors of the AIF; and for ensuring that portfolio or risk management tasks haven been functionally and hierarchically separated from any other potentially conflicting tasks within the delegate/ sub-delegate; and that potential conflicts of interest are properly identified, managed, monitored and disclosed to the investors of the AIF

283. Some respondents asked for clarifying that the requirement of independence in paragraph 2(a) of Box 71 referred to the independence between the portfolio management function and the risk management function.

284. A hedge funds managers’ association asked:

- (i) to clarify that the references to investors in an AIF represented references to such investors in their capacity as investors in the AIF,
- (ii) to clarify what was meant by ‘controlling tasks’ and ‘operating tasks’ and whether the examples under paragraph 43 of the explanatory text could be used, and

- (iii) how the concept of proportionality is to be applied under paragraph 2 of Box 71 in the context of what appeared to be four absolute requirements (i.e. items (a) to (d) under paragraph 2).

285. One respondent asked for the deletion of the reference to the investors of the AIF under paragraph 1 of Box 71.

ESMA's response: ESMA did not agree with the request to clarify that the requirement of independence in paragraph 2(a) of Box 71 referred to the independence between the portfolio management function and the risk management function since the intention was to refer to controlling tasks which are broader than risk management tasks.

- 8. As for the residual requests of clarification of the content of the box, ESMA did not see the necessity to introduce any amendment since the relevant provisions were already sufficiently clear.
- 9. The reference to the investors of the AIF was kept to the extent that it reflected the provisions of Article 20(5)(b) of the AIFMD.

Box 72 – Form and content of notification under Article 20(4)(b) of the AIFMD

286. Respondents generally agreed with the content of Box 72.

287. One respondent suggested that, as for the delegated tasks, a brief outline should suffice for the purposes of the notification and also requested the introduction of a timeframe for the submission of the notification.

ESMA's response: Given the general support received, ESMA did not consider appropriate to amend the content of Box 72.

- 10. As for the timeframe of the submission of the notification, ESMA refers to the provisions of Article 20(4)(b) of the AIFMD which provides that the notification shall occur before the sub-delegation arrangements become effective.

Box 73 – Letter-box entity

288. Respondents generally agreed with the content of Box 73.

289. A private equity association mentioned that the proposal on letter-box entity should not mean that an AIF cannot delegate key functions and asked for deleting item 2 of Box 73.

290. A respondent asked to clarify that a power contained in the AIF's constitution or in a contract between the AIFM and its delegate should suffice to satisfy the condition under paragraph 2 of Box 73.

291. Another respondent mentioned that it would be difficult for an AIFM to become a letter-box entity given that the AIFMD provided that certain functions may not be delegated and responsibility rests with the AIFM; the same respondent suggested that a statement of auditors in the annual audit of the AIFM indicating that they have reviewed/monitored the delegation arrangements should be sufficient to evidence that the entity has not become a letter-box.

ESMA's response: Given the general support received, ESMA did not consider appropriate to amend the content of Box 73.

In the meantime, ESMA clarifies that, provided that the delegation arrangements comply with the relevant delegation rules, the letter-box provisions does not entail that an AIFM may not delegate its functions. ESMA does not consider sufficient a generic auditors' statement confirming that the AIFM is not a letter-box since the compliance with the relevant criteria should be specifically verified on an on-going basis.

Part V: Depositaries

General comments

292. There was some support among respondents for the notion of the depositary's controls applying at the first level only i.e. there should be no look-through approach to, for example, the cash flows of real estate operating and investment business in which the fund invests.
293. Several respondents stressed their preference for an approach based on ex-post controls, particularly with regards to oversight of 'other assets'.
294. One respondent noted that private equity (PE) and venture capital (VC) funds did not generally have depositaries as the nature of the investments had not made them a necessary or useful feature.
295. One association called for the AIFMD and UCITS requirements on oversight duties to be aligned.
296. One stakeholder felt that the L2 measures on depositaries should take due account of the specific role of CSDs and the specific clause in Article 21(10) of the Level 1. The same respondent provided a helpful illustration of how fund depositaries may delegate the securities holdings and how segregation is generally implemented.
297. Looking at the impact of the requirements, one stakeholder was of the view that ESMA's proposals would increase costs by 4-5 times compared to the current regulatory framework, leading many hedge funds managers to relocate their business outside the EU or structure their arrangements with depositaries in such a way (i.e. using synthetic solutions) so as not to hold cash assets in custody. Another association was of the view that the proposals potentially increased systemic risk by leading to a concentration of depositary business among a much smaller number of entities, while two further associations considered that the proposals would effectively make depositaries insurers of the fund industry.

V.I – Appointment of a depositary

1. Contract evidencing appointment of the depositary

1.1 Particulars of the contract appointing the depositary

Box 74

298. The approach taken by ESMA was broadly supported by respondents. Two trade associations welcomed ESMA's approach of basing the requirements on the UCITS framework with a limited number of adaptations. Another association (large majority of members) also welcomed the fact that the list of

particulars was non-exhaustive as this would in their view allow a good level of flexibility. In contrast, one stakeholder sought clarification that the list was in fact exhaustive.

299. One association felt that not all of the elements should be compulsory in all cases and should only be included where relevant.

ESMA's response: In light of the broad support for the approach taken in the draft advice, this has been confirmed in the final advice. More specific comments are addressed below. ESMA confirms that the list of particulars to be included in the contract is not meant to be exhaustive and that the parties have the option of adding further information.

300. The following specific comments or suggested amendments were made:

Paragraph 2

- 'A description of the type of assets that will fall within the scope of the depositary's **safekeeping and oversight** function...'
- the description of the type of assets should also include a description of the geographic zones in which the AIF/AIFM plans to invest as this is an essential information to allow the depositary to fulfil its obligations, such as the requirement to assess and monitor custody risks.
- clarify whether paragraph 2 requires simply a list of the types of asset which may fall within the depositary's function as opposed to a wider description of each instrument.

ESMA's response: ESMA agrees with the suggestions made to clarify the advice and has made corresponding changes in the box and explanatory text.

Paragraph 3

- The text should make a more general reference to the L1 requirements to avoid any misconceptions.
- One stakeholder proposed an amendment (linked to its comments on Box 92) relating to the depositary's obligation to pursue recovery of any loss from its sub-custodians on behalf of the AIF/AIFM.
- It should be made clear that the depositary is not strictly liable for acts or omissions of its unaffiliated sub-custodian.
- The reference to 'objective reason' in the second part of paragraph 3 should be consistent with the advice in Box 92.
- Delete the last part of paragraph 3 in order to be consistent with meaning of 'objective reason to contract a discharge of liability' elsewhere.

ESMA's response: ESMA considers that the interaction of paragraph 3 with the Level 1 text is clear and has therefore made no changes in the final advice. Similarly, issues regarding liability are addressed in a specific section of the advice; as such, ESMA did not consider it appropriate to cover them here.

Paragraph 4

- The procedures by which any new depositary wishes to receive information will not be known at the time of drafting the agreement; the obligation should therefore be to inform the AIFM at the relevant time.
- The agreement should include a maximum time period during which the AIFM must appoint a new depositary and further details of the process to be followed in appointing the replacement depositary (paragraphs 6 and 7 of Box 74 could be used).
- Add a reference to ‘the conditions which are necessary to facilitate transition to another depositary’ in line with Article 33(c) of Directive 2010/43/EC and how the transfer of liability between the two depositaries works in such a scenario.

ESMA’s response: ESMA recognises that not all the details on information will be transferred to the new depositary will be known at the time of drafting the agreement. However, it should be possible to set out the main elements of the procedure that will be followed. Regarding the appointment of the new depositary, ESMA did not wish to prescribe a timetable as this will depend on the individual circumstances. ESMA also highlights that the provisions of paragraph 4 are aimed at facilitating the transition to another depositary.

Paragraph 7

- This goes beyond the UCITS Directive and imposes an obligation on the AIFM which it could not necessarily always fulfil.
- In line with UCITS and paragraph 6 of Box 74, the parties should be allowed to include the necessary information in an SLA rather than the agreement itself.

ESMA’s response: ESMA considers the requirements on exchange of information to be a crucial element of the depositary framework, particularly taking into account the strong liability that attaches to a depositary in the case of a loss of financial instruments. ESMA has therefore maintained the requirement that the depositary must have access to all the information it needs to fulfil its duties.

301. On the second point, ESMA has introduced general flexibility in the box to allow details to be included in the agreement itself or in a service level agreement.

Paragraph 9

- The consent of the depositary is not required for amendments to the AIF’s rules.

ESMA’s response: Paragraph 9 makes clear that the prior agreement of the depositary is not always required for changes to the AIF’s rules.

Paragraph 11

- Two associations specifically supported this provision but one felt the scope should be extended to deal with further delegations so that the full custody chain is disclosed.

ESMA’s response: Wording has been added to the explanatory text to clarify that the requirements in paragraph 11 apply to the whole of the custody chain.

Paragraph 12

- The requirement to provide ‘all information (...)’ is not sufficiently specific and should be replaced by a requirement to provide ‘(Relevant) Information regarding the tasks and responsibilities in respect of obligations relating to anti-money laundering and combating the financing of terrorism’ (same wording as for items 8 and 13).
- ‘all information’ is too imprecise and should be replaced by ‘information recording the allocation of task and responsibilities etc.’
- The text should reflect the situation in those MS (e.g. Italy) in which such obligations do not apply directly to the depositary.

ESMA’s response: In light of the comments made, ESMA has aligned the text with the requirement in the UCITS Directive.

Paragraph 13

- The concept of effective opening of an account should be introduced i.e. when there is active use.

ESMA’s response: ESMA recognised the need for clarification on the point at which the depositary should be informed of the opening of cash accounts. Rather than referring to ‘effective opening’, the final advice states that the information should be provided ‘at’ the opening of an account. ESMA has clarified in the explanatory text that the information should be provided as soon as possible after the opening of the account. This is aimed at allowing the depositary to exercise its cash monitoring duties properly.

Paragraph 14

- Details of the escalation procedures should be able to be included in an SLA rather than the agreement itself.

ESMA’s response: As noted above, general flexibility has been introduced in the box in order to allow details to be included in the agreement itself or in a service level agreement.

Second-last sub-paragraph

- It is the duty of the competent authority, not the depositary, to oversee the AIFM’s conduct of business.

ESMA’s response: ESMA does not consider the duties on the depositary and the competent authority regarding the AIFM’s conduct of business to be mutually exclusive (and indeed the Directive imposes requirements on both in this respect).

Explanatory text paragraph 10

- One respondent noted that the text was considerably more detailed than paragraph 4 of Box 74 and asked ESMA to clarify the minimum required content as regards termination of the contract.

ESMA’s response: Paragraph 4 of the box and the explanatory text in paragraph 10 should be read together in order to clarify the minimum content of the agreement as regards termination of the contract.

302. One respondent felt that the list of particulars to be included in the agreement should also include an undertaking by the depositary to notify the AIFM when it becomes aware that the segregation of assets is not (or no longer) sufficient to ensure protection from insolvency of a sub-custodian in a specific jurisdiction. Similarly, another association called for an obligation to be included on the depositary to require its delegates, as far as is practicable, to comply with the segregation criteria in Box 89.

ESMA's response: ESMA agreed with the proposal to introduce a clear duty on the depositary to notify the AIFM when it becomes aware that the segregation of assets is not sufficient to ensure protection from insolvency of a sub-custodian in a specific jurisdiction (see new text in Box 89, Due diligence). On the second point, this is already addressed by paragraph 3 in Box 90 (Segregation obligation for third parties to which depositaries have delegated part or all of their safekeeping functions (based on Article 16 of Directive 2006/73/EC implementing the MiFID Directive)).

Additional remarks

303. There was general support for the approach whereby it will not be necessary to enter into a separate agreement for each AIF and rely on framework agreements instead, on the basis that this will reduce costs. One association sought more flexibility and highlighted the areas it thought would be more appropriately covered in an SLA (paragraphs 1, 7, 10, 12 and 13).

ESMA's response: As noted above, ESMA has introduced further flexibility on the use of service level agreements.

304. The majority of respondents supported ESMA's decision not to draft a model agreement.

ESMA's response: In light of the broad support for the proposed approach, ESMA has confirmed this in the final advice.

V.II Duties of the depositary

V.III Depositary functions

1. Depositary functions pursuant to §7 – Cash monitoring

1.1 Cash flow monitoring

Box 75 (Cash monitoring – general information requirements)

305. Several respondents broadly supported the proposals while making remarks on specific elements.

306. On the second bullet point, one association was of the view that the duty of the AIFM to inform the depositary prior to the opening of new cash accounts should not lead to an implication that the depositary has any influence in the choice of counterparties at which accounts are opened (in their view this remains an investment decision for the AIFM). Another association proposed that the depositary should be informed 'as soon as reasonably possible' of new cash accounts, noting that in some circumstances cash accounts may derive from implementation of investment decisions that require them to be opened prior to informing the depositary e.g. foreign exchange away from depositary, cash deposits with third-party institutions.

ESMA's response: ESMA has clarified the requirements in this context under Box 74 as well as in the feedback on that box. The duty of the AIFM to inform the depositary should not be seen as im-

plying that the depositary has any influence in the choice of counterparties at which accounts are opened.

307. On the third bullet point, one association sought to limit the scope of the information to be provided to all ‘necessary or relevant’ information taking into account the main objective of the provision i.e. to enable timely access by the depositary to the cash account. Similarly, two real estate associations favoured limiting the obligation to ‘material’ information in order not to capture very small payments, which were likely to be common for real estate funds, while one representative of institutional investors favoured restricting to ‘necessary’ information. More generally, a depositary association suggested adding a reference in the last sub-paragraph to ‘timely and accurate’ information and clarifying that the information envisaged under the third bullet point should be defined in the contract appointing the depositary.

ESMA’s response: ESMA did not consider it appropriate to limit the information to be provided in accordance with the third bullet point on the basis that this information is a key element in allowing the depositary to fulfil its duties.

308. Two investment management associations were of the view that the final sentence of Box 75 presented difficulties as it seemed to impose an obligation of result on the AIFM even though the AIFM may not have all the necessary information and the reference to Article 21 of the Directive was too broad. These associations favoured deletion of the sentence, or at least clarification of the scope of the AIFM’s obligations.

ESMA’s response: ESMA has taken on board the concerns raised and the sentence has been deleted from the final advice.

309. One investment management association felt that no liability should attach to depositary for failure on the part of the AIF/AIFM/third party provider to provide/procure accurate information; that the depositary’s obligations must be understood as applying at the ‘head’ level of an AIF (i.e. at the level of cash accounts actually held by depositary as top level, ‘global’ cash accounts – and not at any other level); and that guidance should not be overly prescriptive as regards how the depositary may discharge its obligation to ensure that an AIF’s cash flows are properly monitored and should have regard to existing processes and procedures where possible.

ESMA’s response: As noted above, issues of depositary liability are addressed in a separate section of the advice. Regarding the level at which the depositary’s obligations apply, it should be understood from the wording of the box that the depositary must have access to all information regarding the AIF’s cash accounts and have a clear overview of all the AIF’s cash flows.

310. One depositary association favoured an amendment stating explicitly that where the depositary has not received the necessary information from the AIFM, the depositary is discharged from its liability provided it has exercised its responsibilities on the basis of the information made available to it.

ESMA’s response: Issues of depositary liability are addressed elsewhere in ESMA’s advice.

311. One real estate association sought clarification that the 2nd bullet point under paragraph 3 of the Explanatory text on p.147 (referring to ‘consent’) was only a descriptive statement that did not imply ex-ante consent. The same association questioned whether it was necessary for the third parties at which cash accounts are opened to provide the information directly to the depositary given that the

explanatory text suggested that the information could be provided by the AIF/AIFM or another entity. Finally, the respondent disagreed with ESMA's decision to take a 'more conservative' approach to the cash booking requirements (c.f. paragraph 13 on p.151 of the CP) on the basis that this was inconsistent with Level 1 and, given the large number of small operational cash flows in real estate funds, it was more appropriate to limit to subscriptions and redemptions.

ESMA's response: On the first point, ESMA has deleted the reference to 'consent', while on the second ESMA has clarified that the information should be provided directly by the third party. On the final point, ESMA has carefully considered the consistency of such an approach with the Level 1. ESMA is of the view that the cash booking requirements should apply to all of the cash flows of the AIF; if this were limited to subscriptions and redemptions only, there is a risk that significant cash flows would not be monitored.

Box 76 (Proper monitoring of all AIF's cash flows)

Q.29 Do you prefer option 1 or option 2 in Box 76? Please provide reasons for your view.

312. Most respondents had a clear preference for option 2; the following reasons were provided as justification:

- The requirement in option 1 to mirror transactions would be very expensive and duplicate the work of fund administrators.
- Option 1 would be operationally impractical and not appropriate from a PE perspective taking into account that commitments are called from investors for specific investments and cash returned upon realisation, rather than pools of money sitting in accounts for long periods.
- Option 1 (paragraph 2(c)) introduced an ex-ante concept which, if interpreted in line with paragraph 8 of the explanatory text, would effectively turn the depositary into a fund manager middle-officer.
- Explanatory-ante controls would interfere with the fundamental relationship between investor and manager.
- The depositary should be responsible for secondary level controls only and the importance of the first level of controls should be reaffirmed.
- Option 1 would involve the depositary becoming part of the primary process of payment and require it to keep track of every operating expense, however minor.
- Simultaneous control of all cash flows would cause substantial delays and derogation in the management, not least because of the extensive liability of the depositary.
- Option 1 would inappropriately restrict distribution options.
- It is not practical for an AIFM to ensure that instructions are sent simultaneously to the depositary and establishing systems would be particularly difficult where multiple bank accounts are involved.
- Option 2 is more proportionate and workable, the emphasis on proper procedures reflects the approach taken in respect of other depositary obligations, reduced duplication and is more cost-effective.

- Option 1 would be operationally challenging, costly and divert the depositary's attention from meaningful oversight and supervision.
- Option 1 would be extremely costly in terms of overhauling IT systems, impractical for depositaries given the number of cash movements (>100,000 per day), and the DVP settlement method provides sufficient protection in any case.
- Option 1 would relieve the AIFM of its duty to properly monitor its cash flows and shift the liability towards the depositary.
- The duplication of record keeping implied by option 1 is not necessary subject to effective systems and controls on which the depositary should have oversight.
- The monitoring required by option 2 would be sufficient to ensure a proper monitoring of all AIF's cash flows.

313. One depositary association could not support option 1 as a general rule but felt it could be acceptable in a limited number of MS and only for depositaries that also perform banking activities (further clarification would also be required on mirroring, particularly whether this was of every transaction or could be carried out ex-post on a regular basis, and whether subscription payments were covered). The same respondent accepted that mirroring cash transactions from the AIF to the depositary would make sense from an economic and efficiency perspective where the appropriate technical infrastructure was already in place at the AIF and did not expect there to be a significant impact in terms of disruption to sales and/or administrative channels. Indeed, this respondent felt that option 1 – provided the ex-ante controls were limited to extraordinary cash movements of the AIF (e.g. 5 times the average) – would facilitate the depositary's control obligations and the co-operation between the AIFM and the depositary.

ESMA's response: In light of the broad support for option 2 and the arguments put forward by respondents, ESMA has confirmed this in its final advice.

314. Regarding the detail of option 2, one investment management association stressed the need to avoid over-prescription on the meaning of the terms 'timely basis' and 'significant cash flow' while highlighting that the depositary should only be required to ensure that procedures are in place to identify inconsistent cash flows but not to make a judgement itself on the inconsistency. The same stakeholder also objected to what it considered to be an overly burdensome provision in paragraph 5 on the basis that it would go beyond the role to be played by the depositary.

ESMA's response: ESMA felt it appropriate not to prescribe further the notions of 'timely basis' and 'significant cash flows', taking into account the broad range of AIFs covered by the Directive.

Paragraph 1

- There should be recognition of the current market practice that where cash accounts are opened in the name of the AIF with a third party, the global proceeds are credited in the account opened in the custodian's book.

ESMA's response: ESMA did not consider it appropriate to make reference to such market practices, bearing in mind that the obligations at Level 1 are clear and will be specified further in the implementing measures.

Paragraph 2

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

ESMA's response: ESMA did not agree with the proposal to limit the reconciliation to cash balances and felt that the original wording was more in line with Article 21(7) of the Directive. ESMA did not wish to specify at which entity the procedures should be in place, as this will depend on the precise operational set-up; the key requirement is that there be procedures in place.

Paragraph 4

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

ESMA's response: ESMA saw merit in clarifying that the relevant cash accounts opened in the name of the AIF should be included in the reconciliation process and has made a corresponding change in the final advice.

Paragraph 5

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

ESMA's response: ESMA agreed with this clarification and has introduced amended text in the final advice.

Q.25 How difficult would it be to comply with a requirement by which the general operating account and the subscription / redemption account would have to be opened at the depositary? Would that be feasible?

315. A large majority of respondents expressed their disagreement with any requirement for the general operating account and the subscription/redemption account to be opened at the depositary pursuant to Article 21(3) and many questioned the compatibility with Level 1 of such a provision. Many respondents felt that such a requirement was not in line with current market practice (e.g. for real estate funds), while two depositary associations believed it would be detrimental to the AIF and ultimately investors due to the adverse impact on distribution channels and increased costs.

ESMA's response: Taking into account the general disagreement among respondents and the arguments put forward, ESMA has not included such a requirement in the final advice.

Box 77 (Ensuring the AIF's cash is properly booked)⁵⁶

316. Several respondents supported the requirements of Box 77. Other respondents made the following specific comments.

Paragraph 1

⁵⁶ This has been merged with the previous box in the final advice.

- Delete ‘or belonging to the third party’ on the basis that it is not possible in practice to book the AIF’s cash separately from cash accounts belonging to the third party. The association that made this comment explained that, where cash is booked with a third party as a deposit, the third party accepts that cash as ‘banker’ with the result that the cash would not be considered to be distinct from cash belonging to it; rather the AIF would only hold a claim as a creditor on the third party.

ESMA’s response: In the final advice, these boxes have been merged; during that process, the reference to ‘or belonging to the third party’ has been deleted.

Paragraph 2

- Insert after the word ‘ensure’ the words ‘that the AIF or AIFM has appropriate procedures in place to ensure that’.
- Delete the references to ‘compelled’ and ‘investment decision’, replace with concept of ‘interests of the AIF’ on the basis that the proposed wording place inappropriate restrictions on the opening of accounts outside the EU (Article 21(7) refers to ‘in the relevant market where cash accounts are required’) and there should be recognition that cash accounts may be opened for other purposes such as to facilitate distribution.

ESMA’s response: On the first point, ESMA did not consider it appropriate to limit the obligation in this way taking into account the clear wording of Article 21(7). On the second point, ESMA agreed with the concerns raised and decided to introduce amended wording in the box so as to ensure consistency with the Level 1 text.

317. One private equity association felt that reference to compliance with Article 16 of the MiFID Level 2 Directive should be deleted as it was unnecessary given the specific obligations imposed by the AIFMD; the same respondent called for the provisions of Article 21(3)(c), permitting non-bank entities to act as depository, to be reflected in the advice as this was particularly important for PE and VC funds.

ESMA’s response: The final advice now refers only to Article 18 of the MiFID Level 2 Directive. For the purposes of cash flows and booking of cash, any entity at which cash accounts are opened that is not covered by that article must be ‘of the same nature’ as such an entity in accordance with Article 21(7). Article 21(3)(c) is not relevant in this context.

Q.26 At what frequency is the reconciliation of cash flows performed in practice? Is there a distinction to be made depending on the type of assets in which the AIF invests?

318. Many respondents provided helpful information with respect to the frequency of the reconciliation of cash flows, while stressing that it was difficult to generalise due to the diversity of AIFs.

ESMA’s response: ESMA thanks respondents for the feedback provided on this point, which gave a clearer picture of current market practice.

Q.27 Are there any practical problems with the requirement to refer to Article 18 of MiFID?

319. The majority of respondents did not anticipate any practical problems.

ESMA’s response: Taking into account respondents’ views, the reference to Article 18 has been retained in the final advice.

Q.28 Does the advice present any particular difficulty regarding accounts opened at prime brokers?

320. Most respondents foresaw no particular difficulties provided option 2 in Box 76 was adopted. In this context, several investment management and depositary associations noted that the depositary would be relying on the prime broker or AIFM to provide sufficient documentation to demonstrate that the requirements of paragraph 2 in Box 77 had been satisfied. Two depositary associations went further, arguing that the AIFM should be held liable for the negligence of the prime broker when the latter does not provide all information to the depositary on a timely basis and that the AIFM should be obliged to require the prime broker to transmit all information to the depositary in order to allow it to carry out its duties.

ESMA's response: In light of the feedback provided, ESMA did not make specific changes with regard to prime brokers in the context of cash monitoring. However, taking into account respondents' concerns regarding the provision of adequate information, ESMA has introduced in Box 82 additional requirements in relation to the information to be provided to depositaries by prime brokers.

Q.30 What would be the estimated costs related to the implementation of option 1 or option 2 of Box 76?

Q.31 What would be the estimated costs related to the implementation of cash mirroring as required under option 1 of Box 76?

321. Most respondents were not able to quantify the costs given e.g. the diverse nature of AIFMs/AIFs, but stressed that option 1 would lead to significantly higher costs due to such factors as the increased number of staff needed. One investment management association estimated the increase in running costs to be between 30-100% (on top of additional costs for building new systems), while one private equity association estimated an increase of 5-10 basis points for basic services and up to 20 basis points if the depositary provides other services.

322. Many stakeholders were not able to quantify the costs but expected significant additional investment in technology, duplication of part of the middle office and valuation functions, fundamental changes in the interactions between the depositary and the fund manager and ongoing support from various teams in order to ensure the provision of adequate data on a timely basis. One respondent gave the example of the significant cash flows accruing to a real estate fund through monthly rents, which in their view would prove very costly to mirror with little benefit in terms of investor protection.

ESMA's response: As set out above, ESMA selected option 2 in its final advice based in part on the feedback in relation to the costs associated with option 1.

2. 1 Definition of financial instruments that should be held in custody

Box 78 (Definition of financial instruments to be held in custody – Article 21 (8) (a))

Q.32 Do you prefer option 1 or option 2 in Box 78? Please provide reasons for your view.

323. There was general support among respondents for the proposed treatment of transferable securities, money market instruments and units of CIUs. However, views were split on the options proposed. Some respondents felt that both options inappropriately narrowed the scope of the depositary's duties

as set out at Level 1. These respondents were of the view that the custody status of an instrument should not be linked to the possibility of its transfer via a settlement system (due in particular to the absence of central depositaries in many non-EU markets). The same stakeholders were also against option 1 as their interpretation was that any appointment of a sub-custodian would bring the assets outside the scope of option 1 (which would be counterintuitive as the sub-custodian is appointed precisely to carry out custody of the assets). There was also concern that option 1 left depositaries too much flexibility to structure the manner in which the assets are held so as to circumvent the provisions of the Directive. For some of these respondents, the decisive criterion should be the substantive power of disposal or claim vested with the depositary in respect of the registered account or held assets, while for others the depositary should be responsible for all financial instruments held in its custody network, with a limited carve-out for assets held directly with the issuer in the name of the AIF, regardless of whether the financial instruments are held on ‘a register maintained by settlement systems’.

324. There was significant support for option 2 for a number of reasons. One investment management association felt that option 1 was unclear and could lead to the inclusion of certain instruments that should be excluded e.g. partnership interests or real estate assets. Another stakeholder supported option 2 as they felt it did not fetter the ability of the AIF to use the financial instruments in whichever way it deems appropriate in the operation of its business, whether to use those assets as margin or security or having to re-register them in the name of the AIF. One banking association, meanwhile, supported option 2 on the basis that the depositary may be unable to verify the existence and location of assets and to retrieve them at any given time through the application of effective operational processes and controls. A real estate association favoured option 2 on the basis that option 1 was unclear, particularly for RE assets; in its view there should be no requirement for assets be registered in an account in the name of the depositary or the depositary’s nominee in order for them to be subject to custody requirements.

325. Two banking associations supported option 2 subject to amendments, notably in paragraph 1 the addition of a reference to the depositary or sub-custodian being the registered holder of the financial instruments and in paragraph 3 the addition of references to regulated central reconciliation procedures and a list of similar non-EU securities settlement systems that would be drawn up by ESMA. Another depositary association supported option 2 provided that it was understood that the financial instruments are held in custody by the depositary within its sub-custody network.

ESMA’s response: ESMA has considered carefully the views expressed by respondents in relation to the financial instruments to be held in custody. The approach taken in the final advice aims to reflect the broad scope of assets covered by Article 21(8)(a), namely ‘all financial instruments that can be registered in a financial instruments account opened in the depositary’s books’ as well as ‘all financial instruments that can be physically delivered to the depositary’. As set out in Article 4(1)(n) of the Directive, ‘financial instruments’ is to be understood as those instruments specified in Section C of Annex I of Directive 2004/39/EC. In the light of the aforementioned provisions, the scope for exempting particular financial instruments seems limited. Regarding the two options identified, ESMA acknowledged concerns highlighted by some respondents about the potential uncertainties raised by option 2, and in particular the concept of ‘similar non-European settlement systems’. On balance, ESMA considered that the reference to instruments registered or held in an account directly or indirectly in the name of the depositary provided greater clarity and was more consistent with the Level 1 provisions. ESMA has also clarified that transferable securities that embed derivatives should be covered.

326. One investment management association felt that the depositary should be under an obligation to inform the AIF/AIFM of any assets belonging to the AIF for which it does not assume the custody function.

ESMA's response: The written agreement appointing the depositary should contain information on the assets that will be subject to the depositary's safekeeping and oversight duties, including which assets will fall in custody.

327. Several respondents commented on the approach taken with regard to instruments that can be physically delivered. One proposal was that instruments that can be physically delivered to the depositary should be held in custody provided that title can be transferred by such physical delivery. On a similar point, another stakeholder favoured referring to financial instruments which are (instead of 'can be') physically delivered in order to avoid giving an incentive to use physical certificates when dematerialisation is possible, while one respondent favoured a reference to financial instruments which have been physically delivered

ESMA's response: ESMA considered it appropriate not to diverge from the wording of Article 21(8)(a) in this context.

328. One association sought clarification on the text in Box 78 relating to the re-use of assets; in their view once a right to re-use has been given and exercised, this will typically involve a full title transfer of securities resulting in a change of ownership.

ESMA's response: ESMA has clarified the approach to re-use of assets in the explanatory text i.e. when the right of re-use has been exercised, the depositary will still be liable to return the asset in the case of loss.

329. One association welcomed the non-exhaustive list of 'other assets' in paragraph 29 of the explanatory text but made three comments:

- the penultimate bullet point should also refer to a 'security interest financial collateral arrangement' where the collateral has been delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral taker (or a person acting on the collateral taker's behalf);
- cash (whether or not booked with a third party) is subject to the provisions of Article 21(7), not Article 21(8)(b) and therefore the distinction between custody assets and 'other assets' is not relevant in this context;
- an additional bullet point should make it clear that investments in privately held companies and interests in partnerships or collective investment undertakings not traded on a regulated market are 'other assets' (c.f. paragraph 26 of Explanatory text).

ESMA's response: On the first point, ESMA has chosen option 2 in the final advice (see further details below). On the second point, ESMA is of the view that cash should be treated as an 'other asset' and that it does not only fall under Article 21(7). Indeed, ESMA considers it contrary to the spirit of the Directive to afford lesser protection to the cash of the AIF than to other assets held in custody or subject to record keeping. As far as the final point is concerned, ESMA is of the view that the definition in the box of financial instruments to be held in custody, taken together with the illustrative

list of ‘other assets’ in the explanatory text, provides sufficient clarity on the distinction to be drawn between the different categories of asset.

Q.33 Under current market practice, which kinds of financial instrument are held in custody (according to current interpretations of this notion) in the various Member States?

330. Respondents provided useful information on the kind of financial instrument currently held in custody. Two banking associations identified transferable securities, money market instruments and units of CIUs, while one explained in detail the various approach taken to custody in the EU and US (rights in rem in securities, approaches in civil law jurisdictions, determination of legal transfer by CSDs in certain jurisdictions).
331. One association explained that in the UK, FSA-authorized investment managers held in their own custody (or through their nominee) the shares in companies, or units in unit trusts belonging to the real estate fund, which companies or trusts invest in turn in land and buildings.
332. One banking association explained that depositaries generally accepted assets for safekeeping if they could collect information on and income from such assets (dividends in the case of stocks/equities and coupons (interest payments) in the case of bonds) and administer related tax withholding documents and foreign tax reclamation, administer voluntary and involuntary corporate actions, provide information on the securities and their issuers such as annual general meetings and related proxies.
333. One settlement system explained that in all EU MS, almost all securities were kept in book-entry form in securities accounts even if the underlying securities are held in physical form.
334. One stakeholder explained that the current market practice was to view assets held in custody much more broadly than proposed under options 1 and 2 in Box 78.
335. Finally, one private equity association noted that PE/VC funds typically did not use custodians because of the nature of the assets held.

ESMA’s response: ESMA is grateful for the input provided by stakeholders on this point, which proved helpful in determining the final position set out in the advice. Nevertheless, ESMA stresses that the intention of the Directive and the accompanying implementing measures is not necessarily to maintain current market practice and that this is only one element to be taken into account in drafting the legislative provisions.

Box 79 (Treatment of collateral – Article 21 (8) (a))

336. Two banking associations supported option 2 on the basis that it provided the necessary flexibility.
337. There was significant support for option 3 on the basis that it had the widest scope, was the clearest of the options and avoided the need for the depositary to analyse the legal effect of each individual collateral arrangement.
338. Although there was support for the use of cross-references to the Financial Collateral Directive (FCD), several associations suggested widening the scope of option 3 to cover collateral arrangements which are not financial collateral arrangements under the Financial Collateral Directive in order to allow greater certainty over equivalent arrangements existing outside the EU. One of these respondents was also concerned that both options 2 and 3 could be interpreted so broadly as to include all types of

possessory security interest available under common law or otherwise (e.g. custodial liens or liens arising via a settlement system or CSD), which could potentially lead to all assets held in dematerialised form being considered as collateral; in order to address this, the respondent suggested qualifying the exemption by referring only to financial collateral arrangements entered into by the AIF and/or the depositary with prime brokers and counterparties, or to exclude from the exemption financial collateral arrangements entered into by the AIF and/or the depositary with persons providing safekeeping-only services.

339. Two respondents noted that the draft advice did not deal explicitly with collateral received by the depositary or any sub-custodians for the benefit of the AIF and that such collateral should be regarded as having been ‘entrusted to the depositary for safekeeping’ within the meaning of Article 21(8).

340. One respondent felt that all collateral arrangements (not just those subject to the FCD) should be covered by the depositary’s general oversight responsibilities as regards the adequacy of the arrangements put in place by the AIFM e.g. reviewing the selection, appointment and ongoing use of the counterparty by the AIFM, the level of the haircut and the enforceability of the agreements.

ESMA’s response: The treatment of collateral is a key part of the definition of financial instruments to be held in custody; as such, the relevant provisions have been merged into a single box in the final advice (Box 79). Although there was a lot of support for option 3 as set out in ESMA’s draft advice, views were mixed and option 2 was considered by some as a good compromise. Taking into account the clear requirements of the Directive with regard to financial instruments that should be held in custody, ESMA took the view that option 2 represented the most appropriate balance between recognition of current market practice and protection of the AIF’s assets. On the other points raised above, ESMA has clarified that collateral received by the depositary or sub-custodian for the benefit of the AIF should be held in custody. Finally, ESMA has clarified that only collateral arrangements within the meaning of the Financial Collateral Directive (or equivalent such arrangements in non-EU jurisdictions, where applicable) should be taken into account for the purposes of determining whether financial instruments provided as collateral should be held in custody. This was done with the aim of having a harmonised approach across the EU, which could have been undermined had any possible collateral arrangement been excluded from the scope of custody, and taking into account the need to have regard to existing parts of the acquis.

Q.34 How easy is it in practice to differentiate the types of collateral defined in the Collateral Directive (title transfer / security transfer)? Is there a need for further clarification of option 2 in Box 79?

341. Respondents expressed mixed views on this point. For some, it was not easy in practice to differentiate between a ‘title transfer collateral arrangement’ and a ‘security financial collateral arrangement’ as the agreement setting out the collateral arrangement was often very complex and would require an in-depth legal analysis to determine to which category the collateral arrangement belonged. In contrast, one depositary association saw no need for further clarification, while other respondents explained that the distinction should normally be clear on the basis of the documentation. One association explained that global custodians and prime brokers already had procedures to identify whether collateral provided is by title transfer or security transfer, and that the Securities Law Directive provided a clear mechanism for identifying where a third party creditor has an interest in the financial instruments used as collateral.

ESMA's response: ESMA is of the view that parties to collateral agreements should be in a position to identify the type of collateral arrangement involved; indeed, this would appear to be a crucial element of the transaction.

2.2 Conditions applicable to the depositary when performing its safekeeping duties on each category of assets

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

342. Several respondents agreed with the general principles and the description of the safekeeping duties. One association stressed the need to minimise duplication with services provided by other service providers (e.g. valuers) to avoid inefficiencies and unnecessary costs.

343. The following specific comments were made.

Paragraph 1(a)

- The wording ‘on its books’ should be added in order to make clear that the requirement relates to segregation at the level of the depositary’s own books and records only.
- ‘registered’ should be replaced with ‘recorded/booked’.
- Unless all assets subject to a security arrangement or right of re-use are excluded entirely from the definition of custody assets (rather than only where that right has been exercised), it would not be possible to completely segregate the assets as proposed e.g. where the assets are held in custody with an agent bank or clearing house, they are generally held in the name of the financial institution rather than in the names of the underlying AIFs.

ESMA's response: ESMA agreed with the need to clarify that the segregation requirement applies at the level of the depositary’s own books and records. However, ESMA preferred to retain the word ‘registered’ for the sake of consistency with the Level 1 text. On the final point, ESMA has set out its approach to the treatment of collateral in Box 79. As noted elsewhere, the requirements set out in the advice may require changes in market practice in the interests of ensuring greater protection of the AIF’s assets.

Paragraph 1(b)

- The standard of care is too high and should be replaced by ‘the due care that would reasonably be expected of a professional custodian...’. The text represents a vague and potentially very high level of obligation without any real legal or regulatory precedent or established standard against which it could be judged.

ESMA's response: ESMA considers the standard of care proposed in the draft advice to be appropriate, taking into account in particular the objectives of the Directive. Given the approach on liability for loss of assets, it is reasonable to require the depositary to apply a high level of care to the assets held in custody (and indeed it will be in the depositary’s own interests to do so). A more detailed explanation of what would be required from the depositary is set out in the explanatory text.

Paragraph 1(c)

- The proposal goes significantly beyond what a depositary could reasonably be expected to assess, particularly as regards custody risks related to settlement systems.
- There should be some limitation on the liability of the depositary in circumstances where it has identified potential risks in a custody or settlement-related situation.
- The specific reference to ‘custody risks related to settlement systems’ is unnecessary on the basis that settlement systems normally deal with the delivery of securities against payment and it is thus the safekeeping of the securities that should be the focus of the custody risk assessment.
- The disclosure requirement should relate to the entire assessment and monitoring process and not be limited to ‘the custody risks related to settlement systems’, and should apply to the entire custody chain (c.f. paragraph 2 of Box 80).

ESMA’s response: ESMA agrees that the text as originally drafted could have introduced uncertainty regarding the depositary’s duties in relation to settlement systems. The text has therefore been clarified to refer to ‘all relevant custody risks’. ESMA has also clarified that the assessment relates to the entire custody chain. Concerning liability, ESMA has set out the interaction between the depositary’s risk-assessment role and the liability framework in the relevant part of the advice.

344. One investment management association requested that paragraph 2 be modified so as to clarify that the depositary is obliged to impose on the sub-custodian that any further delegation will also be on the basis of the segregation requirements set out in Box 89. Two stakeholders, including a representative of institutional investors, favoured elaborating on the concept of ‘due care’ in 1(b) in order to oblige the depositary to:

- know which custodians constitute the custody chain;
- understand the relevant risks that exist at each level of the chain;
- ensure that the due-diligence and segregation obligations have been imposed throughout the chain (from delegate to delegate) at a contractual level;
- ensure that it has appropriate right of access to the books and records of the sub-custodian as well as any of its delegates to ensure compliance with these requirements; and
- document all of the above, make these documents available and report to the AIFM.

ESMA’s response: ESMA agrees that the segregation obligation must apply throughout the custody chain. ESMA also agreed with the desirability of clarifying the obligation of ‘due care’ and has elaborated on this in the explanatory text.

345. A settlement system was of the view that, should ESMA oblige the depositary to carry out a specific assessment of the CSD, this assessment should rely on the regulatory assessment, disclosures and transparency measures already required under ESCB/CESR and CPSS/IOSCO standards applicable to CSDs.

ESMA’s response: in the final advice, the specific reference to assessment of settlement systems has been removed; as such, the obligation on the depositary is to carry out an assessment of all relevant custody risks throughout the custody chain and inform the AIFM of any material risk identified.

Box 81 (Safekeeping duties related to ‘other assets’ – Ownership verification and record keeping)

346. A large majority of respondents expressed a clear preference for option 1 for a number of reasons, including that:

- option 2 would impose significant additional costs without increasing investor protection;
- option 1 was more in line with current market practice;
- option 2 imposed unreasonable obligations on a record keeping function;
- option 2 would involve duplication of part of the clearer or prime broker activity;
- option 1 was the only pragmatic choice;
- a requirement to provide information ex ante to the depositary could hamper the ability of the AIF to transact in its assets.

347. One private equity association considered option 1(ii) as the most practical; they felt option 1(i) was inappropriate as it implied ex-ante controls while option 2 was seen as costly and impractical.

ESMA’s response: Taking into account the broad support from respondents, ESMA’s final advice is based on option 1.

348. Several investment management associations agreed with the merits of having documentary evidence upon every acquisition or sale of a significant asset but called for proportionality e.g. it should not be required for ancillary assets in a real estate fund. Some stakeholders noted that it was not common practice to renew legal real estate title or corporate certification on an annual basis and that it would be preferable to take a risk-based approach to documentation focusing on significant transactions. One real estate association made a general request for flexibility in the requirements on verification of ownership of real estate assets.

ESMA’s response: As the Level 1 text makes no distinction between ‘significant’ and ‘ancillary’ assets, ESMA does not consider it appropriate to introduce one in its advice. Any such distinction would also be likely to lack clarity and lead to uncertainty over which assets should be covered. ESMA has therefore confirmed its approach, which requires the depositary to have a comprehensive overview of the AIF’s assets at all times.

349. One private equity association suggested deletion of the reference to ‘corporate action’ on the basis that this covered dividends; if a corporate action resulted in the issue of more assets then these would be acquired, which was already covered by the text.

ESMA’s response: ESMA has clarified that the obligation relates to corporate actions resulting in the issue of more assets.

350. Regarding the last sub-paragraph of paragraph 3, one private equity association was of the view that the AIFM should have sole discretion to determine whether legal action is needed. The same respondent felt that paragraph 39 of the explanatory text was redundant because Article 21 covered all assets regardless of the use of a particular legal structure. The respondent went on to object strongly to par-

agraph 43 on the basis that the provision of prior information to the depositary would interfere with the current market practice for PE/VC funds e.g. deals subject to last-minute changes, tight deadlines set by third parties, competition among rival bidders etc.

ESMA's response: As set out above, option 2 has not been retained with respect to financial instruments to be held in custody. The additional text foreseen in Box 81 of the CP has therefore been deleted. With respect to provision of prior information, this should not be confused with the concept of ex-ante approval. ESMA has made it clear elsewhere in the advice that ex-ante approval should only be required where both the depositary and the AIFM agree on such an approach.

351. One association sought guidance on the information the depositary would be expected to obtain to satisfy itself of ownership and whether this would vary by asset class or by type of institution holding the asset. The respondent suggested it should be possible for the depositary to rely on client statements or other reports provided by authorised financial institutions as evidence of the ownership right of the AIF, and that where assets are held in physical custody (e.g. commodities) the depositary should similarly be permitted to rely on ownership information provided by the relevant custodian of those assets.

ESMA response: ESMA had already acknowledged in the explanatory text of Box 81 that the depositary may rely on formal and reliable evidence where it considers it appropriate. ESMA has clarified in the final advice that such evidence may be provided by a range of entities.

352. One institutional investor called for the status of cash to be properly analysed and resolved. In its view, cash fell into two broad categories. The simpler scenario involved cash placed with a third party as a result of an investment decision by the AIFM; in that case the AIFM was responsible for selection of the third party and adherence to certain operational standards (Articles 16(1)(e), 16(3) and 18 of MiFID L2) and the depositary should oversee the actions of the AIFM. The second scenario involved uninvested cash, which may be placed with the depositary or, if the depositary does not have the relevant licences or operational capability, the depositary may take the decision to place the cash with a third party. In the former case, the respondent was of the view that the general record-keeping requirements of Article 16 of MiFID L2 applied to the depositary; in the latter case the requirements of Box 89 applied directly to the depositary.

ESMA's response: ESMA is of the view that the depositary's duties with respect to cash should not be limited to those under Article 21(7) and that cash should fall under the heading of 'other assets'. ESMA recognises, however, that it may not be feasible to apply all of the safekeeping duties to cash in the same way as for other assets. ESMA has clarified in the explanatory text that these duties are to be applied to cash 'to the extent possible', but as a minimum that the depositary should at least maintain a record of the cash belonging to the AIF, check the consistency between the positions in its records with those of the AIFM and set up and implement an escalation process for situations where an anomaly is detected.

Q.35 How do you see the delegation of safekeeping duties other than custody tasks operating in practice?

353. One private equity association saw these duties as being in the nature of record keeping and monitoring only.

354. Two depositary associations envisaged few delegation scenarios for safekeeping duties other than custody tasks, with the exception of prime brokers. One of the associations also stressed the need to rely on third parties in many cases in ensuring the depositary has timely access to record etc.
355. One real estate association envisaged the need for depositaries of RE funds to rely on (and contract directly with) a number of third parties such as notaries, lawyers, property managers, title insurers etc.
356. One depositary representative stressed that the depositary would not always appoint a third party who has control and maintains day-to-day records of the underlying asset e.g. where the third party is a delegate or affiliate of the AIFM; in such cases it was the responsibility of the AIFM to ensure that the depositary has appropriate and timely access to records and documentary evidence.
357. Another stakeholder explained that delegation of this part of safekeeping (i.e. delegation of prime brokerage intervention or of record-keeping duties to be performed by the prime broker) was difficult to operate in practice.

ESMA's response: No changes to the advice were made as a result of the points raised by respondents but ESMA is grateful for the feedback received, which helped clarify the way in which safekeeping of other assets will be done in practice.

Q.36 Could you elaborate on the differences notably in terms of control by the depositary when the assets are registered directly with an issuer or a registrar (i) in the name of the AIF directly, (ii) in the name of the depositary on behalf of the AIF and (iii) in the name of the depositary on behalf of a group of unidentified clients?

358. One investment management association saw no significant difference in terms of control and considered that the key control was focused on the parties than can instruct the movement of the assets and/or has the right to claim the assets.
359. Two other respondents saw a difference in that under case (i), the assets could be transferred without the involvement of the depositary which would not be possible (in the absence of fraud) in cases (ii) and (iii).
360. One private equity association considered this notion to be irrelevant to PE/VC funds due to the unique nature of the investments and the existence of transfer restrictions.
361. Two associations explained that in case (i), the depositary must rely on its contract with the AIF to receive the necessary information (this was common market practice for RE and PE funds); in case (ii), the depositary controls the execution of the investment and specific the mailing address and bank accounts that must be used in relation to the assets; while in case (iii), typically involving larger volumes of transactions made on behalf of a number of clients, the operation of an omnibus registration by the depositary provides control and segregation from proprietary assets while offering greater efficiency and automation. Several respondents favoured an approach which would allow all three models to continue.
362. One banking association explained the distinction as follows:
- (i) When the assets are directly registered in the name of the AIF, the depositary should be provided by the AIF with an unquestionable document with regards to the acquisition/sale.

There is no relationship between the depositary and the issuer. A functional relationship, however, may be set up between the depositary and the issuer, whereby the depositary can be granted exclusive authority to give instructions on the account opened in the name of the AIF (or the AIFM).

- (ii) When the assets are registered in the name of the depositary on behalf of the AIF (i.e. in the form of depositary/AIF or depositary /AIFM), the depositary reconciles its positions with the transfer agents.
- (iii) When the assets are registered in the name of the depositary on behalf of a group of unidentified clients (omnibus account), the above processes apply.

363. One investment management association considered that the key principle was the extent to which the asset could be transferred without referral to, and verification by, the depositary rather than the manner of registration.

364. A depositary association stressed that registering in a nominee name did not in itself suggest the asset is held in custody.

ESMA's response: ESMA has clarified in the final advice that financial instruments that are directly registered with the issuer itself or its agent in the name of the AIF should not be held in custody unless the instrument is registered or held in an account directly or indirectly in the name of the depositary. This approach takes into account the fact that the depositary is less able to exercise control over the instrument where that instrument is registered directly with the issuer in the name of the AIF, while recognising the specificities that exist in some Member States (such as registered shares in Germany).

Q.37 To what extent would it be possible / desirable to require prime brokers to provide daily reports as requested under the current FSA rules?

365. A majority of investment management, depositary and prime broker representatives considered it both desirable and feasible for to require daily reporting by prime brokers on the status of their client assets and client money. One investment management association felt this information should be available online for depositaries to access as required. Two depositary associations highlighted information on monitoring of re-hypothecation, segregation and mark-to-market of the assets as being particularly relevant. One prime broker representative, meanwhile, highlighted that the UK rules required the reports to be provided ex post (T+1 minimum) and that any such requirement would have to impose an obligation on the depositary to ensure such reports are made available. One stakeholder felt this would foster a level playing field between prime brokers and depositaries in relation to information on re-use of assets taking into account the requirement in paragraph 8 of Box 74 of the CP.

366. One investment management association considered this issue to be outside the scope of the Commission's request and that any initiative to impose UK FSA-type rules more widely would require a more detailed consultation.

367. Associations of PE/VC funds, RE funds and non-tradeable closed-end funds considered this irrelevant for their sectors.

368. One banking association saw the role and responsibilities of the prime broker as follows:

- i) They should not be considered as prime custodians of the AIF;
- ii) They should not be viewed as a sub-custodian to the depositary when holding assets as collateral but instead they should be required to accept liability on the collateral portion;
- iii) They should be required to provide relevant statements of transactions or, binding statements of holdings to enable the depositary to perform its oversight and record keeping function so as to have a full overview of the assets and the cash movements of the AIF;
- iv) They should be required to provide a daily update (including re-used assets);
- v) Assets of the fund with the PB should be clearly identified and segregated;
- vi) Direct access to reporting lines should be available to the depositary.

ESMA's response: In light of the strong support from broad range of stakeholders for the introduction of specific reporting obligations on prime brokers, ESMA has incorporated this into the final advice. ESMA considers that it had sufficiently detailed feedback on the content of the obligations to allow it include such requirements in the advice and is satisfied that this is in line with the request for assistance received from the European Commission.

Q.38 What would be the estimated costs related to the implementation of option 1 or 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?

- 369. Most respondents were not able to quantify the costs but considered it safe to assume that option 2 would be considerably more expensive due to e.g. additional personnel and IT systems.
- 370. One association felt that option 2 might involve lower costs as it involved fewer requirements on the depositary but was not able to state this conclusively.
- 371. One stakeholder noted that the costs depended on the details of the requirement e.g. a requirement for near-real time record-keeping would involve significant costs.

ESMA's response: As set out above, ESMA's final advice is based on option 1. This choice was based partly on the feedback provided by respondents on the cost impact of the different options.

Q.39 To what extent does / should the depositary look at underlying assets to verify ownership over the assets?

- 372. One investment management association supported requiring a look-through approach by depositaries but felt this should be applied in a proportionate way e.g. by allowing for reliance on appropriate documentary evidence, legal opinions as well as on accredited local auditors (particularly where this is substantial use of intermediary entities e.g. AIFs investing in real estate through an SPV). Similarly, one real estate association stressed that depositaries should be allowed to inspect documents themselves but also to rely on external reports from lawyers, notaries etc.
- 373. Several stakeholders were against a look-through approach in the context of e.g. the assets underlying a CIU. If the question related more to the level of due diligence a depositary should carry out to verify ownership of non-custody assets held directly by the AIF, several respondents were against any prescriptive approach due to the wide diversity of assets covered.

374. One private equity association was strongly against a look-through approach on the basis that this would be impractical and duplicative and felt that the depositary's obligations should be confined to those assets held directly by the AIF.
375. One depositary association was against a look-through approach unless ESMA could provide further guidance on exactly in which circumstances it would be required.
376. One representative of the real estate sector was against a look-through approach except in very limited circumstances (such as in order to discharge its obligation to have oversight of the valuation process under Article 21(9)(b)) and sought confirmation that such a look-through should not include verification of ownership of the underlying (on the basis that for RE funds this would lead to unnecessary and expensive duplication of e.g. verification of title to land and buildings).
377. Another representative of the real estate industry felt that depositaries should look at underlying assets but in different ways depending on how the assets are held (for subsidiary companies it would be sufficient to verify share certifications/registers of SPVs while for direct property ownership there should be verification of title to real estate). More generally, the respondent considered it desirable to rely on contractual controls between the AIF, the AIFM and the depositary.
378. One depositary association believed that the depositary should ensure that the AIF has robust procedures to confirm that assets not held at the depositary are verified by the AIF and reconciled by the administrator.
379. One institutional investor representative supported a look-through approach to the underlying assets of an SPV.

ESMA's response: ESMA has made it clear in the final advice (see paragraph 5 of Box 81) that a look-through approach should be taken to assets held by financial and/or legal structures controlled directly or indirectly by the AIF or the AIFM on behalf of the AIF. This requirement is aimed at preventing possible circumvention of the requirements of the Directive by recourse to SPVs. Taking into account feedback to the consultation, ESMA has specified that in carrying out its safekeeping duties in this context, depositaries may rely on legal opinions and appropriate documentary evidence in order to verify ownership.

3 Depositary functions pursuant to §9 – Oversight duties

Box 82 (Oversight duties – general requirements)

380. The majority of respondents expressed broad support for the requirements and welcomed the focus on ex-post controls and verification of processes and procedures.
381. One investment management association supported, in the interests of efficiency, allowing the use of existing audit, compliance or other materials already produced by the AIF/AIFM for other purposes. The same respondent also sought further clarification on what was meant by 'obligations pursuant to Article 21(9)'.
382. One private equity association suggested wording aimed at limiting the verification duty to those areas under the depositary's responsibility. The same respondent raised strong concerns regarding the reference to ex-ante controls in paragraph 49 of the explanatory text; in their view where this was

the current practice, this should be deemed to satisfy the ex-post verification duties set out in the Directive.

383. Two stakeholders felt that the depositary should not be required to assess the risks associated with the AIFM and considered that this went beyond the L1 text. For one, such a requirement also undermined the AIFM's own fiduciary and regulatory duties on the basis that the AIFM is responsible for establishing its procedures and ensuring compliance with the Directive. Similarly, one prime broker representative argued that oversight should not extend to the risk management of the fund on the basis that this was one of the non-delegable duties of the AIFM. Two other respondents also favoured an explicit statement that the precise details of the depositary's role would depend on the nature, scale and complexity of the AIF/AIFM.

384. One depositary association was of the view that the proposals went well beyond the scope of Article 21. Another felt the provisions should not imply that it is for the depositary to ensure compliance by the AIFM with the Article 20 requirements on delegation.

ESMA's response: Taking into account the broad support from respondents, the requirements set out for consultation are largely unchanged in the final advice. ESMA has also clarified that the requirements are without prejudice to the responsibilities of the AIFM under Article 20.

Box 83 (Oversight duties related to subscriptions/redemptions (a))

385. Many respondents agreed with the proposed advice.

386. One investment management association felt that the depositary should not be required systematically to police the AIF/AIFM's operations and that it should be able to base its actions on information provided by the administrator under contractual arrangements. Similarly, one prime broker representative was of the view that the depositary should only be required to oversee ex post any administrator to which verification of subscriptions and redemptions have been delegated rather than carrying out the verification itself.

387. Private equity representatives proposed adding references to open-ended funds in both points in order to exclude PE/VC funds, for which they considered such obligations to be irrelevant.

388. With respect to the final sub-paragraph, one depositary association felt that the frequency of the depositary's checks should be proportionate to the frequency of subscriptions and redemptions while another favoured determining the frequency of the checks based on the nature, scale and complexity of the AIF and frequency of the calculation of the units or shares.

ESMA's response: ESMA believes that the advice published in July set out clear requirements on the depositary with regard to oversight of subscriptions and redemptions, including the extent to which the depositary should carry out tasks itself or be able to rely on a separate entity. Regarding the requests to refer only to open-ended funds, ESMA has noted that the Level 1 text makes no distinction of this kind. The advice does make clear, however, that the frequency of the depositary's checks should be proportionate to the frequency of subscriptions and redemptions.

Q.43 Regarding the requirement set out in §2 of Box 83 corresponding to Article 21 (9) (a) and the assumption that the requirement may extend beyond the sales of units or shares by the AIF or the AIFM, how could industry practitioners meet that obligation?

389. A large majority of respondents felt it would be practically impossible for the depositary to fulfil such an obligation if it extended to sales in the secondary market and that it should be limited to the verification of information stemming from the AIF's register.

390. One real estate association felt this could only be met in practice by requiring investors to declare their eligibility at the time of the initial investment and ensuring that the AIF's rules or instruments of incorporation require that the eligibility requirements be met on entry and transferred between investors on any subsequent transfer. One banking association felt the obligations could be met at a higher cost if the depositary received access to the relevant information and records of the AIF/AIFM or a third party provider, and if the L2 measures specified that:

- a third party is also obliged to provide the information and records to the depositary;
- the AIF (or the AIFM acting on behalf of the AIF) has to provide independent audit reports about his control/risk environment (e.g. SAS70-reports or equivalent); and
- the AIF (or the AIFM acting on behalf of the AIF) and the third party have to allow on-site visits of the depositary/internal audit function for verification purposes.

ESMA's response: In light of the strong support from the majority of respondents for the approach set out in the draft advice, ESMA has confirmed this approach in the final advice.

Box 84 (Oversight duties related to the valuation of shares or units of the AIF (b))

391. Many respondents felt that the proposals went beyond the scope of Article 21(9)(b) and that they should be limited to valuation of the units or shares of the AIF. As such, the depositary should not be required to directly oversee the valuation of assets or to check that an external valuer has been appointed (the latter being the AIFM's responsibility). Several respondents favoured deletion of paragraphs 1 and 5 and modification of paragraphs 2 and 3 so as to refer to the calculation of the value of units or shares of the AIF.

ESMA's response: ESMA has carefully considered the points raised by respondents in this context and the suggestions that the depositary's duty should be limited to the valuation of the units or shares. However, ESMA maintains its view that the depositary's duty should include the valuation of the underlying assets. Indeed, in ESMA's view it would be impossible for the depositary to be satisfied that the valuation of the units or shares has been done correctly if it is not satisfied of the reliability of the data on which that calculation is based (i.e. the underlying assets).

Box 85 (Oversight duties relating to the carrying out of the AIFM's instructions (c))

Q.44 With regards to the depositary's duties related to the carrying out of the AIFM's instructions, do you consider the scope of the duties set out in paragraph 1 of Box 85 to be appropriate? Please provide reasons for your view.

392. Several associations (representing the depositary and investment management sectors) considered the proposals appropriate and in line with market practice, subject to an amendment to paragraph 1 so as to refer to applicable national law and regulation. There was also support from private equity representatives.

393. Several associations (in the real estate and non-tradeable closed-end funds sectors) considered the requirements generally appropriate but one was against an obligation on the depositary to ensure the

consistency of the AIF's investments with its investment strategy as they felt this would be impossible to meet in most cases for RE funds and could introduce an unacceptable element of subjectivity in the depositary function.

394. Similarly, one prime broker representative was of the view that compliance with investment restrictions and leverage limits should be the primary responsibility of the AIFM. Two other stakeholders shared these concerns and felt that the proposals risked extending the depositary's role into areas which are more properly the duty of the AIFM i.e. ongoing monitoring of investment restrictions and leverage.
395. One association asked for the principle of ex-post verification of legality of an instruction to be included in the Box and was critical of paragraph 63 of the Explanatory text, noting that there was no justification for different treatment of physical assets and financial instruments that cannot be held in custody. A prime broker representative raised a concern on the same paragraph on the basis that it may not be possible to reverse a transaction in all cases and that this would in any case overlap with the direction of the investment activity of the AIF.
396. One banking association stressed that having an effective risk management process remained the responsibility of the AIF/AIFM and that the depositary's duties should consist of assessing the control procedures and environment at the AIF/AIFM on an ex-post basis.
397. One investment management association felt the depositary's obligations should extend to ensuring that suitable procedures exist and are maintained and noted that it was not for the depositary to make a qualitative assessment of individual trades.
398. One depositary association favoured deletion of the reference to 'unusual transactions' in paragraph 62 of the Explanatory text on the basis that it went beyond the L1 text and could lead to confusion as to the correct interpretation, and sought clarification on the first sentence of the same paragraph.
399. Two associations voiced strong concerns on the reference to ex-ante controls in paragraph 63 of the explanatory text, which one (from the private equity sector) saw as being beyond the scope of the L1 and inappropriate for PE/VC funds.
400. Two depositary associations were of the view that paragraph 1 went beyond the L1 text as the latter referred to 'incorporation document' rather than offering documents, which could change without the depositary's knowledge.
401. One prime broker representative sought further guidance on how a depositary should assess whether procedures are 'proportionate to the nature, scale and complexity of the AIF.'

ESMA's response: The proposals set out for consultation in July are largely unchanged in the final advice. However, ESMA did agree with the suggestion to limit the verification of compliance to applicable national law and regulation. Regarding some of the comments made about the duties in this context being more appropriately the role of the AIFM, ESMA considers that this should not prevent the depositary from having a role of oversight and verification. ESMA is also of the view that such duties flow naturally from the requirements on depositaries more generally.

Box 86 (Duties related to the timely settlement of transactions (d))

Q.45 Do you prefer option 1 or option 2 in Box 86? Please give reasons for your view.

402. A majority of respondents supported option 1 on the basis that, inter alia, the L1 requirement was sufficiently clear, the additional requirements in option 2 would not add value or safety, the depositary should not be required to ‘police’ receipt of consideration, option 2 was more appropriate for funds investing in frequently-traded instruments and option 1 provided the appropriate level of flexibility.

403. Two associations (for real estate and non-tradeable closed-end funds) supported option 2 but sought further guidance on the meaning of ‘usual time limits’ in the context of RE funds. Similarly, one real estate representative, which had no strong preference for either option, stressed that for RE funds, there were no ‘usual time limits’ for transactions in privately-held companies.

404. One settlement system explained that where settlement of securities occurred on a delivery versus payment (DVP) basis, it was not possible for the AIF to have delivered securities or cash without having received the related cash or securities. The same respondent acknowledged, however, that additional procedures could be necessary for settlement of transactions that did not occur on a DVP basis.

ESMA’s response: Although a majority of respondents supported option 1, many of those stakeholders considered that the provisions under option 2 were broadly in line with existing market practice. Taking this into account, and also bearing in mind that ESMA was specifically requested by the Commission to elaborate on the duty as set out at Level 1, ESMA considered it more appropriate to confirm option 2 in the final advice.

Box 87 (Oversight duties relating to the AIF’s income distribution (e))

405. Two investment management associations were of the view that some of the provisions went beyond the Level 1. Regarding paragraphs 1 and 3, one of these respondents felt that the depositary’s duty should be to ensure that appropriate procedures were in place. Many respondents also disagreed with the requirement in paragraph 2 that the depositary should ensure an appropriate follow-up of any reserves expressed by the AIF’s auditors (some considered this to be the AIFM’s responsibility).

406. The following specific comments were made:

Paragraph 1

- Many respondents were of the opinion that the depositary’s oversight duties could only be triggered once a decision had been made by the AIFM to distribute. The same comment was raised by some in relation to paragraph 3.

Paragraph 2

- Two depositary associations could only accept such a requirement if the AIF/AIFM was required to provide the depositary with all information on possible reserves expressed on the financial statements. Another depositary representative favoured deletion of the text as they felt that the depositary’s role should be limited to responding to relevant matters affecting fund assets or other issues relevant to its duties but should not include a direct responsibility to follow up on financial statements.

Paragraph 3

- One banking association was of the view that this requirement overlapped with the responsibilities of the external auditor and called for clarification on the extent to which oversight could be delegated to auditors.

ESMA’s response: Although respondents raised some concerns about the extent of the depositary’s duties in this context, ESMA maintains its view that the depositary’s duty should not be limited to mere verification of procedures. ESMA did recognise, however, the need to clarify that the duties set out in paragraphs 1 and 3 were only triggered once the AIFM had made a decision to distribute. Amendments have been made to the text in order to take this into account. With respect to the obligation on the depositary to ensure appropriate measures have been taken where the AIF’s auditors have expressed reserves on the annual financial statements, ESMA has clarified that the depositary should be provided with all information on such reserves.

Q.40 To what extent do you expect the advice on oversight will impact the depositary’s relationship with funds, managers and their service providers? Is there a need for additional clarity in that regard?

407. Many respondents welcomed the principles-based approach proposed by ESMA.

408. One banking association set out a number of principles they believed should be followed in the application of the oversight duties such as a focus on secondary-level controls, an ex-post approach, no specification of the means of controls, proportionality and alignment with UCITS. The same respondent also favoured adding a reference to some specific pieces of information the depositary should be provided on commencement of its duties (e.g. risk management procedures, detail on the reserves expressed by the AIF’s auditor etc).

409. One depositary association expected a limited impact in those MS where depositaries already perform a similar role to that envisaged by the advice (e.g. Luxembourg or Germany) and a much more significant impact in other MS e.g. the UK, particularly for RE and PE funds.

410. One banking association felt the oversight duties were very extensive and that the corresponding obligations on the AIFM to e.g. grant rights to access were missing.

411. An institutional investor was generally supportive of the advice on oversight duties but had some concerns on how this would be implemented in practice since some of the duties would be new to AIFs. In particular, the respondent wondered to whom the depositary would escalate matters as set out in the third paragraph of Box 82.

ESMA’s response: ESMA took into account the feedback provided by stakeholders on this point when finalising the advice on the depositary’s oversight duties.

Q.41 Could potential conflicts of interest arise when the depositary is designated to issue shares of the AIF?

412. Several respondents (covering investment management, depositary and institutional investor representatives) felt that there may be situations in which a conflict of interest would arise and that such situations should be addressed by ensuring that there are adequate procedures in place to segregate both functionally and hierarchically the functions of depositary and transfer agents or that the provisions in the Directive on functional and hierarchical separation and Article 20(2)(b) on delegation were sufficient safeguards. Similarly, three depositary associations felt that the requirements in the

AIFMD on prevention of conflicts of interest should allow the same legal entity to act as depositary and transfer agent (investor protection being ensured by the use of Chinese walls).

413. One investment management association was of the view that issuance of shares was a matter for the AIF and its administrator, and that the only role for the depositary related to receipt of subscription proceeds and its oversight duty under Article 21(9)(a).

414. One private equity association saw a potential for conflicts and stressed the need for the oversight and manager role to remain separate.

ESMA's response: Since most respondents felt that any conflicts of interest in this context would be addressed by the requirements on functional and hierarchical separation, ESMA did not introduce any further changes in its advice.

Q.42 As regards the requirement for the depositary to ensure the sale, issue, repurchase, redemption and cancellation of shares or units of the AIF is compliant with the applicable national law and the AIF rules and / or instruments of incorporation, what is the current practice with respect to the reconciliation of subscription orders with subscription proceeds?

415. One stakeholder noted that in certain jurisdictions, this was done by carrying out oversight of the transfer agent e.g. on-site inspections to review processes and controls and sample testing of shareholder activity.

416. One investment management association considered this activity to be somewhat removed from the depositary function due to the involvement of the administrator, noting that the depositary's role would extend to ensuring that appropriate investor acceptance and reconciliation procedures were in place.

417. From the real estate perspective, one stakeholder explained that corporate funds and some institutional real estate funds may be unitised, in which case there is internal reconciliation of subscription orders with subscription proceeds; in contrast, many 'private equity real estate funds' were not unitised and they dealt with reconciliations internally. The same stakeholder added that, in a closed-ended fund, subscription did not happen at the same time as funding, which is drawn down over time as investments are made thereby removing the need for reconciliation.

418. Several depositary associations stressed that the verification of procedures by the AIF/AIFM should not necessarily be correlated to the frequency of subscription and redemption and that periodic verification was sufficient; as such, the additional layer of complexity inherent in some transactions (equalisation methods, commissions, retrocessions) should fall outside the scope of the depositary's oversight.

419. Two respondents explained that the current practice is that the depositary:

- i) on a periodic basis, ensures that the AIF, the AIFM or the designated entity (transfer agent and administrative agent) have appropriate procedures in place to reconcile the subscription orders with the subscriptions proceeds;
- ii) ensures that the procedure is reviewed on a regular basis and updated if necessary;
- iii) checks to ensure consistency between the total number of units or shares in the AIF's accounts and the total number of outstanding shares or units that appear in the AIF's register.

420. One banking association supported the aim of aligning the AIFMD and UCITS requirements on oversight duties as set out in paragraph 54 of the Explanatory text.

421. One institutional investor representative explained that for AIFs with depositaries, this function was usually performed by the administrator which would then make the reconciliations available to the depositary for review. For AIFs that currently did not have depositaries, the AIFM undertakes the function, which is subject to independent audit as part of the preparation of the annual accounts.

ESMA's response: ESMA is grateful to respondents for providing additional information on the current market practice in this context, which was taken into account in the finalisation of the advice.

Section 2 Due diligence duties

Box 88 (Due Diligence Requirements)

422. Many respondents generally supported ESMA's proposals but made a number of specific drafting suggestions.

423. One investment management association welcomed ESMA's proposals but sought clarification that in the case of delegation by a sub-custodian of its custody functions, the due diligence requirements should apply mutatis mutandis to the relevant parties in the custody chain (in line with the requirements on segregation in Box 89, paragraph 3).

424. Two depositary associations welcomed the proposals, which they considered to be in line with market practice, but regretted the fact that ESMA had not chosen to develop a comprehensive template of evaluation, selection, review and monitoring, which in their view would have helped clarify the duties of depositaries.

ESMA's response: In light of the broad support from respondents for the requirements on due diligence are largely unchanged in the final advice. ESMA did, however, remove the reference to enforceability of contractual agreements in light of comments from some respondents that this created unnecessary confusion. A requirement has also been introduced on the depositary to notify the AIFM where the depositary becomes aware that the segregation of assets is not, or is no longer sufficient to ensure protection from insolvency of a sub-custodian in a specific jurisdiction. This addresses a number of requests made by investment management representatives with respect to Box 74. Finally, ESMA has added some text to make clear that the requirements of paragraph 1 apply all along the custody chain.

Section 3 Segregation

Box 89 (Segregation obligation for third parties to which depositaries have delegated part or all of their safekeeping functions (based on Article 16 of Directive 2006/73/EC implementing the MiFID Directive))

425. Many respondents considered the requirements adequate and reasonable.

426. Several stakeholders sought clarification on the practical implications of paragraph 5 on p.176 of the CP in relation to the extension of segregation to record keeping (in the case of such a requirement, there was some support for the notion that it should be limited to cases where the depositary has ap-

pointed the delegate). Two associations felt that depositaries would not have a role in appointing the third parties carrying out record keeping and considered such a requirement as going beyond L1.

427. One investment management association asked for the reference in the explanatory text to the use of omnibus accounts by sub-custodians to be included in Box 89. On a related point, a prime broker association believed that the L2 measures should take full account of the fact that the local laws/market practices of certain jurisdictions in which a sub-custodian operates may require that all assets be held in a single account. One institutional investor had no objection to the use of omnibus accounts provided there was no adverse impact on the level of investor protection. Two depositary associations supported the absence of a requirement to segregate assets on a fund-by-fund basis and the possibility to use omnibus accounts, in line with current market practice.

428. Two depositary associations noted that further segregation requirements with respect to cash at sub-delegate level would not add protection to cash holdings in case of an insolvency of the sub-delegate (whether in the EU or elsewhere). The same respondents favoured deletion of paragraph 1(e) on the basis that cash is recognised as a fungible asset and should not be segregated, and of paragraph 2 on the basis that the depositary could not be expected to assess national insolvency frameworks. In contrast, one institutional investor considered paragraph 2 a key requirement and felt that it should be supplemented by a disclosure obligation to the AIF/AIFM. The same stakeholder agreed with the approach set out in paragraph 3 to apply the requirements *mutatis mutandis* along the custody chain on the basis that this would give comfort both to the depositary and the AIFM that the level of protection of the AIF's assets is not diluted by subsequent delegations.

ESMA's response: In drafting the advice in this context, ESMA has kept in mind the need to have strong duties in the case of 'other assets' that fall outside the scope of the custody obligation. ESMA is keen to avoid a situation in which the holding of assets can be structured in such a way that the custody obligation (and the associated liability regime) is avoided. ESMA has therefore considered it appropriate to confirm the need for segregation with respect to 'other assets'.

ESMA also considered it appropriate to align the segregation requirements as closely as possible with the provisions of Article 16 of the MiFID Level 2 Directive, in the interests of cross-sectoral consistency. The way in which this has been done in paragraph 1(a) in particular takes due account of the reference in recital 40 to the use of omnibus accounts for multiple AIFs.

Q.46 What alternative or additional measures to segregation could be put in place to 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?

429. One investment management association explained that the current market practice was for depositaries to open single beneficiary account, often at sub-custodian and central securities depositary level.

430. The following additional steps that could be taken by depositaries in order to have additional protection of the assets were identified:

- Disclosure to the AIF and AIFM so that this aspect of custody risk is properly taken into account in the investment decision

- Depositories taking such measures as possible in the local jurisdictions to make the assets as ‘insolvency-proof’ as possible based on local law advice
 - Depositories might undertake appropriate levels of ongoing monitoring to ensure that the relevant sub-custodian continues to comply with the criteria for selection set out in Box 88 – this may involve an enhanced level of credit monitoring or enhanced levels of reconciliations work or other measures to pick up any early warning signals of potential problems
 - Crucially, foreign players can be a powerful voice to incentivize legislators, regulators, local market participants in a jurisdiction to improve their client asset protection regimes or processes
 - More frequent reconciliations
 - Use of buffers
 - Prohibitions in temporary deficits in client assets
 - Putting in place arrangements prohibiting the use of a debit balance for one client to offset a credit balance for another
 - Assets should be registered in the name of the fund (or its general partner in the case of a limited partnership) so as to avoid any questions about segregation ().
431. Several associations felt there should be a recognition that local legislation and court decisions prevailed in all disputes and that the depository could not ensure that assets held by a sub-custodian are fully protected from insolvency by means of segregation.
432. One investment management association considered that where such additional measures might be unduly burdensome or significantly increase costs, the AIF should not be obliged to make use of them subject to appropriate disclosure to prospective investors.
433. One investment management association noted that in relation to paragraph 2 of the Box, the depository should be obliged to notify the AIF/AIFM when it becomes aware that segregation of assets is not sufficient to ensure protection from insolvency of a sub-custodian in a specific jurisdiction; in the absence of such a notification, any assets lost as a result of the insolvency should not be considered an external event in accordance with Box 91.
434. One depository association felt that all that could be reasonably expected was for the depository to seek clarification of confirmation as to the conditions under which assets are held while stressing that sub-custodians would not be able to provide certainty as to legal effect.

ESMA’s response: ESMA is grateful to respondents for helping to identify possible additional measures that could be taken by depositaries in order to protect the assets where segregation is not recognised. These measures have been included in the explanatory text in order to provide concrete steps that can be taken by the depository. Regarding the comments made in relation to the role of local court decisions, it is clear that such decisions will be crucial in many cases. However, the role of the implementing measures is to provide a clear framework for the entities involved and which may be taken into account in any legal proceedings that arise.

Q.46 In which countries would this be the case? Please specify the estimated percentage of assets in custody that could be concerned.

435. Most respondents were not able to identify in which countries such risks would arise. However, a member of one investment management association estimated that it was acting through single beneficiary accounts in about one third of the 105 markets in which it operates. These assets, held mostly in emerging markets, accounted for approximately 3% of total holding for the firm in question. The association concerned asked ESMA to draw up and make public a list of relevant jurisdictions.

436. Another association identified the following jurisdictions as not recognising the concept of beneficial ownership: Argentina, Indonesia, Mexico, Pakistan, Russia and Thailand.

437. One depositary association considered it difficult to draw up a list of jurisdictions as it would be subject to change due to constantly changing legislation and added that issues related to assets being more exposed to insolvency or benefiting from less protection related more to the AIF's risk management policy than the depositary's liability.

ESMA's response: ESMA is grateful for the feedback provided on this point. At this stage ESMA considers that it would be difficult to draw up a list of countries, particularly given the apparent lack of information among market participants.

V.IV. The depositary's liability regime

1 Loss of financial instruments

Box 90 (Definition of loss)

438. There was broad support among respondents (covering investment management and depositary representatives) for the approach taken in the advice.

439. One investment management association felt that the depositary should be bound to co-operate in good faith to the documented process set out in Box 90, paragraph 2, and to share with the AIFM any document or evidence likely to facilitate the assessment of the loss. Regarding the penultimate subparagraph, the same respondent took the view that it should be for the depositary to monitor the insolvency proceedings rather than the AIFM.

440. Several stakeholders sought clarification of 'stated right of ownership' (they preferred a reference to the financial instruments themselves being lost or to the AIF's right of ownership in order to avoid any claimed right of ownership being captured – condition (b) would then become unnecessary). These respondents were also of the view that not being able to dispose of an instrument did not necessarily result in a loss. One private equity association proposed an amendment to cover situations where the assets cannot be disposed of due to an insolvency affecting the issuer of an investment or the effect of a contractual provision agreed by the AIFM.

441. One depositary association made the following points:

- the depositary should not be liable for events outside its sphere of control and influence; as such, where fraud has been committed whereby the financial instruments never existed, there should be no obligation to return the assets.
- liability should attach to the depositary only in case of a 'wrongful action or omission' of the depositary;

- the requirement to notify investors should be clarified, in particular what approach should be taken in case of a dispute over whether there has been a loss and/or whether such loss is covered by the liability exemption of an external event;
- a depositary cannot ‘determine’ whether the assets are lost in the case of insolvency of a sub-custodian as this is ultimately a matter for the courts; at best a depositary could provide a non-binding preliminary assessment.

442. One institutional investor representative felt that the ‘loss’ was defined too narrowly and proposed the following alternative: ‘the AIF is unable to directly or indirectly dispose of the financial instruments having regard to the reasonable expectation of investors in the AIF.’ The same respondent also felt that in the case of the insolvency of an affiliated sub-custodian (‘affiliated’ to be defined broadly), financial instruments should be considered lost upon the opening of the insolvency proceedings in relation to that sub-custodian. Finally, this stakeholder believed that the determination of whether an asset is lost should be made by the AIFM in consultation with the depositary.

ESMA’s response: The requirements on the definition of ‘loss’ are key in that they represent the first step towards determining the liability of the depositary to return the asset or a corresponding amount. Taking into account the broadly positive feedback on this aspect, ESMA did not make substantial changes in the final advice. ESMA did consider it appropriate, however, to reflect comments from some respondents in order to clarify that the ownership right referred to in paragraph 1(a) should be that of the AIF. On balance, ESMA also agreed that the obligation to monitor the insolvency proceedings should apply both the AIFM and the depositary. Finally, ESMA has clarified that the obligation to inform investors is triggered regardless of whether the depositary has been, or is subsequently held liable for the loss and obliged to return financial instruments of an identical type or the corresponding amount.

2 External events beyond reasonable control

Box 91 (Definition of ‘external event beyond the depositary’s reasonable control, the consequences of which were unavoidable despite all reasonable efforts to the contrary’)

443. Respondents expressed mixed views on ESMA’s proposals in this area. Some stakeholders supported the proposal on the basis that it was consistent with the principle set out in Article 21(13) i.e. that the depositary’s liability is not affected by any delegation. Others considered that it would be reasonable for the depositary to be exonerated from liability provided that it has fulfilled the segregation and due diligence requirements set out in the Directive. An intermediate position was held by some respondents, namely that paragraph 1 could be restricted to cover acts and omissions of sub-custodians that are affiliates of the depositary.

444. A number of respondents were of the view that acts and omissions of an unaffiliated sub-custodian should be presumed to be ‘external’ and set out a number of arguments as to why it would be inappropriate to take a different approach (e.g. this would represent a de facto amendment of L1 and lead to increased capital costs). There was willingness among some of these stakeholders, however, to envisage considering events at affiliated sub-custodians as ‘internal’.

445. One settlement system agreed that loss of securities resulting from fraud, insolvency or default of a clearing or settlement system (which would be very unlikely) should be seen as an external event beyond reasonable control.

ESMA’s response: ESMA recognises that it is difficult to identify an approach on this point which would attract strong support across both the investment management and depositary sectors. In reaching a final view, ESMA focused in particular on the provision in Article 21(13) of the Directive that the depositary’s liability is not affected by any delegation, as well as the general principle that the same event occurring at the level of a sub-custodian should be treated in the same way as if it had happened at the depositary itself. From that perspective, ESMA did not feel it was appropriate to take a different approach for affiliated versus unaffiliated sub-custodians, as the depositary should be aware of the possible significant consequences of a delegation in all cases.

Box 91

Paragraph 1

- Two depositary associations felt that only improper acts or failures of the depositary should be captured; one added that the obligations referred to should be limited to those set out in the Directive.

ESMA’s response: As set out above, ESMA did not see merit in restricting the responsibility of the depositary in this way and was concerned that a reference to ‘improper’ would leave too much scope for interpretation. ESMA also considered limiting the scope of the obligations to those set out in the Directive but took the view that important obligations could also arise on the basis of e.g. contractual agreements. ESMA did, however, feel it necessary to clarify the wording in paragraph 1 of the box (‘The event which led to the loss ~~did~~ is not ~~occur~~ as a result...’).

Paragraph 3

- Three depositary associations felt that there should be a reference to ‘reasonable efforts’ instead of ‘rigorous and comprehensive due diligences’.
- Two other respondents favoured deletion/clarification of the text on the basis that this overlapped with the responsibilities of the AIFM as required by Article 8(1)(c) of the Directive.

ESMA’s response: The term ‘reasonable efforts’ used in the Level 1 text is expanded on in points (a) to (c) of paragraph 3. ESMA deliberately chose the term ‘rigorous and comprehensive due diligences’, meanwhile, in order to set a high standard for the due diligence to be done by the depositary both with regard to its own internal structure and, where relevant, when selecting a sub-custodian.

ESMA considers that the duties of the depositary as set out in the box, and in particular the requirement in paragraph 3(a), do not overlap with those of the AIFM pursuant to Article 8(1)(c) of the Directive. It is natural that the depositary will be required to have a good level of knowledge and expertise in relation to the nature and complexity of the assets of the AIF in order to be able to perform its duties. This is without prejudice to the AIFM’s role as investment manager.

Paragraph 3(a)

- One depositary association called for the text to be revised to qualify the depositary’s obligation to monitor for any external events with a duty to act reasonably.

ESMA’s response: ESMA agreed with the suggestion and introduced revised wording (‘external event it could reasonably identify’) in the final advice.

Paragraph 3(c)

- One depositary association suggested deletion of the text on the basis that the reference to ‘appropriate actions...to prevent or mitigate a loss of financial instruments held in custody’ could cause problems where the situation is not clear enough for the depositary to know whether it should independently take a decision.

ESMA’s response: ESMA notes that it is impossible to identify exhaustively all the circumstances which may arise in the market and has therefore focused on developing clear principles that will help market participants in complying with their obligations. ESMA considers paragraph 3(c) important in that it imposes an obligation on the depositary to take remedial action where appropriate in order to prevent or mitigate loss.

Explanatory text

Paragraph 29

- Two depositary associations disagreed as they felt that fraud at a sub-custodian should be considered external provided the depositary has satisfied the due diligence requirements. One of the associations was of the view that the proposed approach amounted to imposing strict liability on depositaries.

ESMA’s response: As noted above, ESMA took into account the clear requirements of the Directive in reaching its view on the appropriate approach to take in relation to depositary liability. The first step of the assessment of whether the depositary is liable to return a lost asset is to determine whether an event is ‘external’. To the extent that an event occurring at the level of the sub-custodian should be treated in the same way as an event occurring at the depositary itself, the event cannot be considered ‘external’ and the liability to return the asset or a corresponding amount is triggered.

Paragraphs 38 & 39

- Several respondents expressed concerns about the proposal set out in paragraphs 38 and 39 under Box 91 on the basis that, inter alia: it was not realistic and too long; it did not strike the balance that ESMA was seeking; it could create legal uncertainty in times of crisis; the depositary should not be expected to carry out a quasi-investment management function; the depositary would not necessarily know the identity of the investors. Two depositary associations added that where the depositary has made a notification to the CA, it should be discharged of liability for any resulting loss. The same respondents also suggested requiring AIFMs to cover this in the pre-investment disclosures to investors under Article 23(d).

ESMA’s response: ESMA maintains its view that, in order to balance the roles and responsibilities of the AIFM and the depositary in circumstances of the type described in paragraphs 38 and 39 of the CP, the possibility for the depositary to discharge its liability or terminate the contract should not be ruled out. Indeed, these measures provide a good incentive on the AIFM to take into account the depositary’s warnings and to act before a discharge of liability or termination of the contract becomes necessary.

3 Objective reasons to contract a discharge

Box 92

446. A large majority of members of one investment management association disagreed with the proposal in option 2, considering it incompatible with the L1 text in the sense that the existence of a written contract did not – in their view – by itself constitute an objective reason. This association preferred option 1 for reasons of clarity. An institutional investor representative took a similar view, arguing that option 2 was too open-ended and that it was hard to envisage circumstances in which an AIF/AIFM, acting in the interests of the investors of the AIF, would explicitly agree to discharge the depositary’s liability in circumstances beyond those set out in option 1.

447. Many other respondents supported option 2 on the basis that, inter alia, it was clearer and more objective, any other approach would favour the largest banks, it was the most pragmatic option and the notion of ‘best interests of the AIF and its investors’ was too broad, option 1 did not provide legal certainty on such notions as ‘no other option’ and ‘agreed...it is in the best interest’, and that it gave the necessary flexibility.

ESMA’s response: Having reflected further on the two options in the light of feedback from respondents, ESMA took the view that neither of the alternatives set out in the CP was fully appropriate. In particular, ESMA agreed with the concerns raised with respect to option 2, such as that it was too open-ended and raised questions of consistency with the Level 1 text. However, ESMA was also of the view that option 1 as drafted, taking into account the additional flexibility in the new paragraphs 44 and 45 of the explanatory text, did not strike the necessary balance. Option 1 was redrafted, therefore, in order to give the AIFM the responsibility to determine whether it is in the best interests of the AIF and the investors for the depositary to discharge its liability.

Q.47 What are the estimated costs and consequences related to the liability regime as set out in the proposed advice? What could be the implications of the depositary’s liability regime with regard to prudential regulation, in particular capital charges?

448. A study commissioned by one investment management association suggested that a ‘strict liability’ approach for acts or omissions of all sub-custodians would increase costs by 4-5 times.

449. One private equity association foresaw a significant increase in costs due to the resulting need for depositaries to price risks they face into their charges and the need to duplicate work done by others e.g. auditors.

450. Several respondents expected a significant increase in costs for depositaries as well as an increase in systemic risk.

451. Two stakeholders noted that assuming AuM of AIFM of €2 trillion (as set out in the Commission’s original Directive proposal), even a one basis point increase would lead to additional costs of €200 million.

452. One prime broker representative explained that if depositaries were effectively made strictly liable for losses of assets, this would most likely be considered a contingent liability against which regulatory capital of 8% would need to be held. This respondent was of the view that this would be beyond the ability of the AIF industry to absorb and would discourage most prime brokers (who currently provide custody services for the vast majority of hedge funds balances) would no longer offer such services, or would have to significantly increase costs in order to do so. The same respondent highlighted what it saw as potentially significant systemic risks arising from such an approach.

ESMA's response: ESMA took into account the information provided on possible costs in finalising its advice. However, ESMA also had to pay close attention to the proper interpretation of the Level 1 Directive, as set out above, which foresees a strong approach to depositary liability.

Q.48 Please provide a typology of events which could be qualified as a loss in accordance with the suggested definition in Box 90.

453. One investment management association felt that a principles-based approach as set out in Box 90 was more appropriate than a typology, which would inevitably fail to capture certain circumstances. Several banking associations agreed but proposed the following non-exhaustive typology:

a) A stated right of ownership is uncovered to be unfounded because it either ceases to exist or never existed:

- Fraud resulting in the permanent loss of the financial instrument

b) the AIF has been permanently deprived of its right of ownership over the financial instruments:

- Nationalisation of the issuer – the financial instruments of the issuer are nationalised, expropriated or are otherwise required to be transferred to any governmental agency, authority or entity.

c) the AIF is permanently unable to directly or indirectly dispose of the financial instruments:

- Change in relevant law e.g. due to the adoption of or change in any applicable law or regulation (including tax laws) it becomes illegal to hold, acquire or dispose of the financial instruments.
- In some cases, government action may result in 'loss' e.g. where a government (or governmental institution or agency) has taken action which had the effect of permanently and irretrievably preventing the transfer, sale or other disposition of the financial instruments.
- In some cases, national or international embargoes i.e. a government (or government institution or agency) or an international organisation has announced a trade embargo affecting the ability to transfer, sell or dispose of the financial instruments) may be sufficiently permanent that the
- Liquidation, dissolution or winding up of issuer (ESMA rightly recognises, only where it becomes certain during (or at the end of) the insolvency process that the financial instruments are permanently and irretrievably lost).

454. One investment management association identified the following circumstances based on the proposed definition in Box 90:

(a) Fraud resulting in the permanent loss of the financial instruments

(b) Nationalisation of the issuer

(c) Change in relevant law, government action, national or international embargoes and liquidation, dissolution or winding up of issuer.

455. One institutional investor representative did not see the need for a typology if the definition in Box 90 was retained.

ESMA's response: ESMA is grateful to respondents for the input provided with respect to a possible typology of events that would constitute a loss. However, ESMA did not consider it necessary to include such a typology in its advice and is of the view that the definition in Box 91 is sufficiently clear.

Q.49 Do you see any difficulty with the suggestion to consider as an external event the fact that local legislation may not recognise the effects of the segregation requirements imposed by the AIFMD?

456. The majority of respondents supported this approach although some sought clarification on the 'effects of segregation'. One depositary association recommended that the reference to local legislation not recognising 'the effects of segregation' be extended to the decisions of 'courts and regulatory bodies'. One institutional investor representative explained that investors were not expecting depositaries to underwrite custody risk but insisted on the need for proper disclosure, as well as application of the requirements on due diligence and ongoing monitoring.

ESMA's response: Taking into account the support of the majority of respondents, ESMA has confirmed this approach in its final advice. Segregation is a well-known concept in the world of financial services; as such, ESMA did not see a need to define 'effects of segregation' further at this stage.

Q.50 Are there other events which should specifically be defined/presumed as 'external'?

457. One investment management association was of the view that no event should be a priori defined as external (even acts of God) and that an assessment should always be made taking into account all the facts and circumstances.

458. One banking association also preferred a principles-based approach but identified all operational failures outside the sphere of influence of the depositary and its network as well as claims of third parties to be the true legal owner of a financial instrument. The same respondent also saw merit in extending Box 65 (Objective reasons for delegation) to depositaries.

459. Two associations identified the following non-exhaustive list:

- Acts or omissions of an unaffiliated sub-custodian
- Any event, the occurrence of which might reasonably be considered to be part of the general risk of investing.
- Liquidation, dissolution or winding up of an issuer.
- National or international embargoes.
- Nationalization, strikes, devaluations or fluctuations, seizure, expropriation or other government actions, or other similar action by any governmental authority, de facto or de jure; or enactment, promulgation, imposition or enforcement by any such governmental authority of currency restrictions, exchange controls, levies or other charges affecting the financial instruments.
- Breakdown, failure, malfunction, error or interruption in the transmission of information caused by any machines, utilities or telecommunications systems.

- Any order or regulation of any banking or securities industry authority including changes in market rules and market conditions affecting the orderly execution or settlement of financial instruments transactions or affecting the value of financial instruments.
- Acts of war, terrorism, insurrection or revolution.

460. One institutional investor representative also identified acts, omissions and insolvency of a securities depository or settlement system as an external event, along with events pertaining to country risk, political risk and/or market risk.

461. Two depository associations provided a detailed list of events covering the following broad categories: i) settlement system rules, market practices or other market infrastructure-imposed constraints; ii) Local market problems; iii) Local market conditions; iv) Appointment of counterparties by AIFM; v) Other external events.

462. One depository association identified the unavailability of infrastructure as a difficult issue, particularly where the infrastructure is owned or operated by third parties and the only relationship the depository has with the owner or operator is through a services contract or software licence (the respondent's view was that in the latter case, the event should not be considered 'internal').

ESMA's response: Taking into account the mixed views expressed by stakeholders on this point, ESMA decided to maintain its principles-based approach to the determination of external events.

Q.51 What type of event would be difficult to qualify as either 'internal' or 'external' with regard to the proposed advice? How could the 'external event beyond reasonable control' be further clarified to address those concerns?

463. Several respondents reiterated their views that the proposed advice would limit unreasonably the types of event that would qualify as 'external' and that the depository's sphere of influence was limited.

ESMA's response: As noted above, ESMA decided to maintain its principles-based approach with respect to the distinction between external and internal events.

Q.52 To what extent do you believe the transfer of liability will / could be implemented in practice? Why? Do you intend to make use of that provision? What are the main difficulties that you foresee? Would it make a difference when the sub-custodian is inside the depository's group or outside its group?

464. One investment management association was of the view that many sub-custodians would be unwilling to assume liability over and above their own fraud (and possibly negligence) and that such transfers could come up against practical difficulties in any case (such as laws not permitting third party rights).

465. One private equity association was keen to avoid an approach that drove business into banks with huge proprietary networks.

466. Two depository associations envisaged transfers where the AIF wishes to make use of prime brokers and sub-custodians that did not meet the eligibility criteria for depository banks, or where a particular sub-custodian is imposed on the AIF by the depository, but noted that it might be difficult to imple-

ment in practice as a result of local of harmonisation of regarding the definition and requirements to achieve an effective transfer of liability.

467. One banking association saw difficulties in implementing such transfers in practice due to the inherent disadvantages to the sub-custodian, except where the depositary acts with the sub-custodians (and their local jurisdiction) and accepts that the AIF (or the AIFM) may directly place a claim with regards to assets in custody.

468. One prime broker representative considered it unlikely that sub-custodians within the prime broker's custodial network would accept any direct right of recourse from the prime broker's clients, given that there is no direct relationship with the AIF.

469. One depositary association was particularly concerned about the references in paragraphs 42 and 45 of the Explanatory text under Box 92 relating to the transfer of liability all along the custody chain, noting that the UK 'Contracts (Right of Third Parties) Act 1999' would mean that no sub-custodian arrangement could be changed without the consent of each and every AIFM acting for AIFs holding assets through the sub-custodian. More generally, this respondent was concerned that a proposal providing for potential transfer of liability to sub-custodians would detract from the depositary's fundamental role of selecting the best sub-custodian available.

470. One banking association doubted the feasibility of transferring the liability in practice on the basis that sub-custodians were unlikely to accept.

ESMA's response: The possibility for the depositary to discharge its liability is envisaged by the Directive. ESMA has clarified in its advice the circumstances in which the depositary should be considered to have an objective reason to do so. It will be for market participants to decide to what extent they wish to make use of this option taking into account the requirements of the Directive and the future implementing measures.

Q.53 Is the framework set out in the draft advice considered workable for non-bank depositaries which would be appointed for funds investing mainly in private equity or physical real estate assets in line with the exemption provided for in Article 21? Why? What amendments should be made?

471. One investment management association considered the advice to be workable assuming that the assets were not to be considered 'financial instruments that can be held in custody' under Article 21(8).

472. One private equity association reiterated its concerns regarding the lack of tailoring for PE/VC funds using non-bank depositaries and cross-referred to its specific proposals elsewhere in the response.

473. Two depositary associations favoured limiting the extent to which non-bank depositaries could act as custodians for financial instruments. A third felt the framework was workable for PE and RE funds, provided option 2 was chosen in Box 78 and option 1 in Box 81.

474. One banking association stressed the need to ensure a level playing field in the EU and for third countries between all depositaries.

ESMA's response: In developing the advice on depositaries, ESMA has sought to ensure a level playing field between depositaries that are credit institutions and those that are not, also with respect to the level of protection given to the assets of the AIF.

Q.54 Is there a need for further tailoring of the requirements set out in the draft advice to take into account the different types of AIF? What amendments should be made?

475. One depositary association sought further tailoring of the distinction between custody and other assets and highlighted its desire to see consistency between the UCITS and AIFMD frameworks.
476. One banking association saw a need for greater tailoring with regard to the 'beyond reasonable control' test, on the basis that what is reasonable for a more 'traditional' AIF may not be reasonable for an AIF engaged in intra-day trading.
477. For one depositary association, the key tailoring required was in the distinction between safekeeping duties in respect of financial instruments held in custody versus other assets subject to record keeping and oversight duties.
478. One banking association felt the more diversified nature of AIFs (compared to UCITS) had to be taken into account but not to the detriment of harmonisation.

ESMA's response: Throughout its advice, ESMA has made efforts to tailor the requirements to the different types of AIFM where appropriate. With respect to the distinction between financial instruments to be held in custody and 'other assets' for the purposes of safekeeping, the reasoning behind ESMA's advice is set out elsewhere in this document.

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

Box 93: General provisions on calculating the exposure of an AIF

479. Many respondents strongly disagreed with the proposal in Box 93 to require the calculation of the AIF according to two or even three different methodologies, as well as, the disclosure of the level of leverage based on two methodologies. Calculation based on a single methodology should be enough and the choice of the calculation methodology should be left to the AIFM.

ESMA's response: ESMA carefully analysed the call from many respondents to calculate the leverage according to only one method instead of two and potentially three. However, ESMA was not convinced by stakeholders' arguments and remains convinced that there should be at least two different calculation of the leverage according to the gross method and the commitment method. In addition to these two calculations, if it deems appropriate, AIFM may calculate the leverage according to a third method (the advanced method) after having notified its competent authority.

Box 94: Exposure related definitions

480. For many respondents, the definitions of netting and hedging arrangements were highly restrictive and did not reflect the market practice.

ESMA's response: ESMA decided to keep the definition unchanged in order to ensure the comparability with the Commitment Approach as defined in the CESR guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS. However, Box 94 has been deleted in the final advice and the definitions have been included in the relevant boxes.

Box 95: Gross method of calculating the exposure of the AIF

481. Several respondents pointed out that for funds that almost invest entirely in futures the outcome of the gross or commitment methods did not provide with an appropriate indication of the risk incurred. The same respondents also pointed out that borrowings should be excluded from the gross method when they are reinvested – as the re-investment is already captured.

482. Several respondents strongly disagreed with the use of gross method as proposed by ESMA. According to them, the most appropriate method should be an adjusted commitment/gross method. However, some respondents believed that the gross method could be used for reporting obligations to competent authorities with some modifications.

483. An alternative method was proposed by investment manager association. This method consisted in treating derivatives exposures in the line with the treatment of derivatives under Basel III regime which as recently proposed in the CRD IV.

ESMA's response: ESMA believes that information on the level of leverage calculated on the basis of the gross exposure is of utmost importance in the context of monitoring systemic. Moreover, further information on the level of the leverage calculated according to the Commitment Method will allow competent authorities and investors to understand the impact of the netting and hedging arrangements on the leverage of the AIF.

Box 96: Commitment method of calculating the exposure of an AIF

484. For many respondents, the definitions of eligible hedging arrangement were too restrictive and unhelpful and some members of the of the trade association considered important that ESMA should ensure consistency of the commitment method with the UCITS calculation methodology for the commitment approach.

485. The proposition to take into account hedging arrangements only when there is no return generated and where the sole aim is to eliminate a countervailing risk was not supported by several respondents. However, while being too strict, the same respondents welcomed the possible use of netting arrangements which permit duration matching rules for interest rate strategies.

ESMA's response: ESMA believes that there should be consistency between the methods used by UCITS management companies and AIFM to calculate the exposure of the funds and that method should be aligned to the UCITS method as provided by the CESR guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS. Therefore, the rules applicable to netting and hedging arrangements have not been modified and additional provisions of the CESR guidelines have been introduced in the final advice (exclusion of derivative instruments from the calculation of the exposure of the AIF under certain circumstances and duration netting rules as provided by Box 3, 4 and 7 of CESR guidelines).

Box 97: Advanced method of calculating the exposure of an AIF

486. Several respondents disagreed with the requirement to calculate the advanced method besides the commitment method, instead of as an alternative to it.

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

ESMA's response: Following the feedback received from the consultation, ESMA has decided not to change the approach. Indeed, the Advanced Method has been introduced in order to relax the rules applicable to the Commitment Method with in particular the possibility for AIFM to use offsetting arrangements which are not allowed under the Commitment Method. ESMA believes that the Advanced Method should only be used on a voluntary basis in addition to the Gross and the Commitment Method which are compulsory. However, in terms of information to be provided to investors under Article 23 of the Directive, AIFM, in addition to the Gross Method figure can choose between the Commitment Method and the Advanced Method. It has also been agreed that ESMA would develop guidelines in order to provide more details in the application of the Advanced Method.

Box 98: Method of increasing the exposure of an AIF

488. It was suggested by some respondents to better align the definition of futures contract and forward agreements with the definition of the CESR guidelines on Risk Measurement and the Calculation of the Global Exposure and Counterparty Risk for UCITS.

ESMA's response: When necessary, the definitions have been aligned to the CESR guidelines on Risk Measurement and Counterparty Risk for UCITS.

Q55: ESMA has set out a list of methods by which an AIF may increase its exposure. Are there any additional methods which should be included?

489. Respondents to the consultation expressed some support for the proposed list and suggested the inclusion of additional methods such spread betting or credit default swaps.

ESMA's response: Based on the feedback received, ESMA added to the list of methods for increasing the exposure of the AIF the definition of spread betting and credit default swaps.

Q56: ESMA has aimed to set out a robust framework for the calculation of exposure while allowing flexibility to take account of the wide variety of AIFs. Should any additional specificities be included within the Advanced Method to assist in its application?

490. Many respondents to the consultation took advantage of answering this question to reiterate their call to ESMA to reconsider the use of VaR as an alternative to the gross and commitment method where appropriate for the particular AIF.

491. It was pointed out that the calculation of exposure seemed to be designed for hedge funds and not for private equity or venture capital funds. Therefore, it would be appropriate and proportionate for ESMA to include an additional, simple test to determine whether a given private equity and venture capital AIF is leveraged or not.

ESMA's response: As explained above, ESMA kept the advice unchanged with regards the calculation of the exposure in accordance with the Advanced Method. Furthermore, ESMA disagreed with the suggestion made by several respondents to introduce the possibility of calculating the leverage according to the VaR. Indeed, ESMA is of the view that the VaR is not a measure of the leverage which is defined as the ratio between the exposure of the AIF and its net asset value. ESMA acknowledges that UCITS can use the VaR but only in the context of the calculation of global exposure. Indeed, Box 24 of CESR's guidelines on Risk Measurement and the Calculation of Global Exposure requires UCITS management companies calculating the global exposure of the funds according to the VaR approach to disclose in the prospectus the leverage of the UCITS as a separate figure.

Q57: Is further clarification needed in relation to the treatment of contingent liabilities or credit-based instruments?

492. According to several respondents there was no need for further clarification.

493. For one stakeholder, in order to avoid the risk of inconsistent valuations and duplicative costs, ESMA's advice should provide that the valuation of contingent liabilities and credit-based instruments should be based on the accounting principles used in the AIF's financial statements determined in accordance with the Directive.

ESMA's response: Based on the comments received from the consultation, ESMA did not feel necessary to provide more information in relation to the treatment of contingent liabilities or credit-based instruments.

Q58: Do you agree that when an AIFM calculates the exposure according to the gross method as described in Box 95, cash and cash-equivalent positions which provide a return at the risk-free rate and are held in the base currency of the AIF should be excluded?

494. The majority of respondents agreed that when an AIFM calculates the exposure according to the gross method, cash and cash-equivalent which provide a return at risk-free rate and held in the base currency of the AIF should be excluded. Some of these respondents also felt that the definition 'cash and cash equivalent' should be addressed.

ESMA's response: In light of the feedback received, ESMA has decided to keep the approach taken in the consultation paper unchanged and to exclude from the calculation of the exposure according to the gross method cash and cash-equivalent. As suggested by some respondents, ESMA has decided to provide more clarity on the definition of cash equivalents which provide a return at the risk-free rate. In the final advice, ESMA recommends that cash equivalents should be assets which are highly liquid investments held in the base currency of the AIF that are readily convertible to a known amount of cash, subject to an insignificant risk of changes in value and which provide a return no greater than the rate of the 3-month high quality government bond

Q59: Which of the three options in Box 99 do you prefer? Please provide reasons for your view.

495. Respondents to the consultation did not express a strong preference for one of the three options identified and proposed by ESMA.

ESMA's response: see question 61 above.

Q60: Notwithstanding the wording of recital 78 of the Directive, do you consider that leverage at the level of a third party financial or legal structure controlled by the AIF should always be included in the calculation of the leverage of the AIF?

496. Respondents to the consultation expressed mixed views on this question.

497. For some respondents, leverage in a third party entity should only be included in respect of a particular AIF if there was legal recourse such that the AIF's liability exceeds its investment value.

498. For other stakeholders, leverage at the level of a third party financial or legal structure controlled by the AIF should be included in the calculation of the leverage of the AIF on a consolidated basis where material, particularly in the case of real estate funds which prepare their financial statements on a consolidated basis. For these respondents, failing to require the disclosure of such leverage under AIFMD, where material, would ignore a potential source of systemic risk and could lead to market distortions. Indeed, AIFs that hold assets directly would appear to have higher leverage than AIFs that hold assets indirectly through subsidiary special purpose vehicles entities; leverage in the latter case would not be reported. The trade association pointed out that currently, non-listed real estate funds typically report leverage on a consolidated basis, which leads to a clearer and more directly comparable disclosure of risk associated with such leverage.

ESMA's response: Based on the mixed views expressed by respondents ESMA decided to take the following approach. Any exposure which is contained in any financial and/or legal structures involving third parties controlled by the relevant AIF should be included in the calculation of the exposure where the structures referred to are specifically set up to directly or indirectly increase the exposure at the level of the AIF. However, for AIFs whose core investment policy is to acquire control of non-listed companies or issuers, AIFM should not include in the calculation of exposure any leverage that exists at the level of those non-listed companies and issuers. ESMA believes that this approach provides clarity on how Recital 78 of the Directive should be interpreted.

Possible Implementing Measures on Limits to Leverage or Other Restrictions on the Management of AIF

Q61: Do you agree with ESMA's advice on the circumstances and criteria to guide competent authorities in undertaking an assessment of the extent to which they should impose limits to the leverage than an AIFM may employ or other restrictions on the management of AIF to ensure the stability and integrity of the financial system? If not, what additional circumstances and criteria should be considered and what should be the timing of such measures? Please provide reasons for your view.

499. Some stakeholders disagreed with the proposed approach and believed that it was going beyond what is required in the Level 1 Directive. According to them, the proposal should be restricted to limiting leverage only 'to the extent to which the use of leverage contributes to the build-up of systemic risk in the financial system or risks of disorderly markets' as envisaged in the Level 1 Directive.

500. It was stressed that leverage was not a measure of risk and that therefore, any intervention should be based on sound analysis and evidence of systemic risk.

Q62: What additional factors should be taken into account in determining the timing of measures to limit leverage or other restrictions on the management of AIF before these are employed by competent authorities?

501. The majority of respondents believed that these powers should be used only in extreme circumstances to avoid any perverse effect on assets prices. Stakeholders were also of the view that the process of deleverage should be carefully analysed by competent authorities prior to any decision due to the systemic implication it may have.

ESMA's response: ESMA recognises the concerns expressed by some respondents that any decision by competent authorities to limit leverage should be done after due consideration of the potential impact on assets prices. However, ESMA disagreed with the point made by some respondents that the approach taken by ESMA was going beyond what is required in the Level 1 and decided not to change the advice. Indeed, ESMA believes that the approach provides competent authorities with guidance on the criteria to be considered when assessing the potential impact on the stability and integrity of the financial system.

Possible implementing measures on annual reporting

Box 101: Definition of material change

502. Clarification was asked whether the proposed definition of 'material change' was relevant only to specific transparency requirements and without prejudice to other AIFMD provisions containing references to material changes.

503. For some respondents it was unclear how this definition would work in the closed-ended fund context. According to them, the proposed definition would introduce ambiguity to a process that is currently clearly laid out in the governing documentation of such funds and allows for a certainty of investor oversight. The same respondents also stressed that in a closed-ended fund, investors did not typically have a right to 'reconsider' their investments and felt the determination of whether information would lead an investor to 'reconsider' its investment was subjective. Rather than linking the definition to the subjective determination of a hypothetical investor, the advice should provide that whether a material change has occurred be determined in the reasonable judgment of the AIFM.

504. In relation to the definition of the term 'material', it was suggested that reference should be made to the practitioner's framework for the Preparation and Presentation of Financial Statements approved by the IASC in 1989 and adopted by the IASB in 2011.

ESMA's response: ESMA believes that the proposed definition of material change would also be applicable to closed-ended funds. Indeed, reconsideration of their investment rights by investors does not mean automatically that investors would ask for redemption but could also cover other rights.

Box 102: General principles for the annual report

505. Several respondents indicated that the AIFMD was unclear as to whether the requirement to produce (as distinct from 'to make available') an annual report applies to the AIFM or the AIF. According

to these respondents, the ESMA's consultation paper continues the ambiguity and they would recommend that it be resolved expressly by recognising that while, under level 1, Article 22, the AIFM is obliged to make available an annual report to investors in relation to the funds it manages, the preparation of several components of that report properly belong to the governing body of the AIF itself. Accordingly, it was suggested that the AIFM may discharge itself of its obligations to make disclosures under Article 22, to the extent that disclosure obligations are met by the governing body of the AIF.

506. It was also recommended that, as under UCITS, where the governing body of the fund prepares the annual statements, the document containing them can be supplemented by the inclusion of an annual Investment Managers Report (a mechanic which is contemplated but not explored in Paragraph 25 on page 225 of the CP).

507. Some stakeholders also believed that the second sentence of paragraph 3 should be deleted as it was not the role of the AIFM to determine what level of information is appropriate for an investor. A similar comment was made for the second sentence of the paragraph 4 and it was also suggested to delete the first sentence of paragraph 4 which was felt to be duplicative with paragraph 3.

508. According to several respondents, ESMA's proposal should not impede AIFMs or AIFs established in an EU-member state to prepare annual reports in accordance with US GAAP and suggested moderating the provisions of paragraphs 2 and 3 of Box 102 to avoid any suggestion that this was the intent.

ESMA's response: ESMA has decided not to take on board the comment made by some respondents that the provisions of paragraphs 2 and 3 of Box 102 should be modified in order to make sure that AIFM or AIF established in an EU-member state can prepare annual reports in accordance with US GAAP. Indeed, Article 22(3) of the AIFMD provides that 'accounting information given in the annual report shall be prepared in accordance with the accounting standards of the home Member State of the AIF or in accordance with the accounting standards of the third country where the AIF is established and with the accounting rules laid down in the AIF rules or instruments of incorporation'. Therefore, ESMA does not consider that such clarification should be provided in the advice.

Box 103: Reporting material changes for the annual report

509. It was proposed that only the first sentence of paragraph 3 should be kept because some respondents felt that it was not the role of the AIFM to speculate as to what additional information may be relevant for an investor. Additionally, the suggestion was made to delete the phrase 'together with any potential or anticipated impact on the AIF and/or investors of the AIF' in paragraph 4.

510. One respondent proposed to align the wording of paragraph 3 with the wording of paragraph 4.

ESMA's response: ESMA agreed with the comment made to align the wording of paragraph 3 with paragraph 4 and modified the advice accordingly.

Box 104: Primary financial statements

511. Respondents were broadly supportive with the ESMA's proposal. However, some of them disagreed with paragraph 7 (a) (iii) to present unrealised gain because this would be in contradiction with reporting practices in many countries. For some respondents, the distinction between realised gains and unrealised gains was unnecessarily prescriptive and should be deleted. For one respondent that

disagreed with this distinction as well, should ESMA see the necessity to ensure a harmonised presentation of un-realised gains for AIFs, this information should be in the overview of AIF performance to be included in the report on activities.

ESMA's response: see question 63 below

Box 105: Content and format of the report on activities for the financial year.

512. According to many respondents, paragraphs 24 and 25 of the explanatory text should be moved to Box 105.

513. Several respondents recommended that the phrase 'containing also a description of the principal risks and investment or economic uncertainties that the AIF may face' should be deleted, given that there would already be sufficient disclosures made in accordance with Article 23 of the Directive. The same should apply to paragraph 3 as well according to the two European associations.

514. Some respondents stressed that this report should be the responsibility of the governing body of the AIF, and not the AIFM, unless there was no governing body of the AIF.

ESMA's response: ESMA did not deem appropriate to move paragraphs 24 and 25 from the explanatory text to Box 105 and disagreed with the deletion suggestion made by some respondents. Therefore, Box 105 was not changed in the final advice.

Q63: Do you agree with the approach in relation to the format and content of the financial statements and the annual report? Will this cause issues for particular GAAPs?

515. The vast majority of respondents supported the approach proposed by ESMA and some drafting suggestions were done.

516. However, one respondent strongly encouraged ESMA to ensure that private equity and venture capital AIFs and AIFMs may use US GAAP when compiling financial statements and the annual reports.

ESMA's response: Some drafting modifications were made by ESMA and in particular the advice no longer refers to AIFM preparing financial statements as according to the Directive AIFM are not required to prepare the financial report but only to make the information available to investors.

Q64: In general, do you agree with the approach presented by ESMA in relation to remuneration? Will this cause issues for any particular types of AIF and how much cost is it likely to add to the annual report process?

517. Several respondents considered that remuneration disclosures should be subject to similar exemptions as are available to firms under Directive 2006/48/EC, which effectively allow information which is immaterial, confidential or proprietary to not be disclosed. According to them, the implementation of similar exemptions would ensure a level playing field across all firms subject to remuneration disclosures, which was one of the original objectives of the G20 when remuneration proposals were first tabled.

518. ESMA was also asked to clarify whether in the case of umbrella funds the remuneration disclosures should be at sub fund level or umbrella level.
519. Several stakeholders drew ESMA's attention to the fact that when AIF are incorporated as a separate legal entity, those responsible for the financial statements of the AIF will be those in charge of the corporate governance of the AIF. They may differ from the management of the AIFM. In this case, there are likely not to have a direct access to the AIFM records and thus not to be in a position to take responsibility and ownership for such disclosures. Moreover, the auditor of the AIF may not have direct access to the books of the AIFM in order to audit such disclosure.
520. Paragraphs 5 and 6 were considered as going beyond the requirements of the Level 1 and their deletion was suggested.
521. It was also stressed that the proposed provisions would be prejudicial to small managers as individual payments made to principals managing the AIF would be easily identifiable.
522. In the case of large non-listed real estate funds, the disclosure of total remuneration in relation to staff involved in the operations of the AIF was deemed to be impossible.

ESMA's response: ESMA agreed with the suggestion to delete paragraphs 5 and 6 of Box 106. Also, in the final advice, in paragraph 2 of Box 106 a reference to the number of beneficiaries was added as well as a new paragraph 3 with the mention of carried interest. These amendments were made to reflect better the Level 1.

Possible Implementing Measures on Disclosure to Investors

Box 107: Periodic disclosure to investors

523. Several respondents were of the view that AIF with no periodical redemptions rights should only be required to disclose information relating to paragraphs 1, 2 and 3 in its first disclosure to investors and not be required to do it on a periodical basis. Also, they felt the second part of paragraph 5 under the heading 'Risk Management systems employed by the AIFM' to onerous and not necessarily of immediate interest to all investors. Therefore, this information should be made available to investors on request.
524. It was stressed that Box 107 should be modified to reflect differences among different types of AIFMs and to be consistent with substantive provisions of the AIFMD and related implementing measures. In particular, Box 107 should clarify that disclosure requirements related to liquidity management do not apply to unleveraged closed-ended AIFs in accordance with Article 16 of the Directive.
525. It was proposed that paragraphs 2, 6 and 7 of Box 107 should contain 'whenever there any material changes' and to add a sentence making clear that paragraphs 4 and 5 did not apply to AIFM in so far as they manage unleveraged closed-ended AIF.

ESMA's response: ESMA did not see any valid reason for allowing AIF with not periodical redemptions rights to disclose the information under paragraphs 1, 2 and 3 only in their first disclosure. Indeed, the fact that investors in these AIF do not have the possibility to redeem their shares or units on a periodic basis is not reason for not disclosing the percentage of assets subject to special arrangements. How-

ever, ESMA agreed with the comment made about paragraph 4 of Box 6 and clarified that it was not applicable for unleveraged closed-ended AIF.

Box 108: Regular disclosure to investors

526. Several respondents expressed some concern on the fact that the draft technical advice was placing too much importance on leverage and in particular gross leverage as useful statistic for regulators and investors. While these respondents generally supported the general proposed approach requiring timely disclosure only in respect of ‘material changes’ to the maximum leverage and permitting inclusion of information on the actual maximum amount of leverage in the AIF annual report, they were concerned about the requirement to set a maximum level of leverage that must comply with at all times.

Q65: Does ESMA’s proposed approach in relation to the disclosure of 1) new arrangements for managing liquidity and 2) the risk profile impose additional liability obligations on the AIFM?

527. One respondent believed that for disclosure of risk profile, ESMA should avoid adopting UCITS requirements which are ill-suited to the diversity of AIF risk.

528. Several stakeholders believed that disclosure of new arrangements may impose additional liability (including, but not limited, to conflicts of interest, insider trading, fraud and breach of fiduciary duty) where certain investors are informed of certain special arrangements that do not concern them as in the case of liquidating special purpose vehicles or side pockets.

529. According to some respondents there should not be any notification of the activation of liquidity management tools that have been disclosed to investors in prospectus and offering documents.

Q66: Do you agree with ESMA’s proposed definition of special arrangements? What would this not capture?

530. According to some respondents, permanent borrowings and gates should not be considered as special arrangements as they typically apply to all investors.

ESMA’s response: Following the feedback received ESMA decided to exclude gates from the definition of special arrangements.

Q67: Which option for periodic disclosure of risk profile under Box 107 do you support? Please provide reasons for your view.

531. The majority of respondents expressed a preference for option 1 as it offers more discretion in making disclosure and should result in higher quality information being provided to stakeholders.

ESMA’s response: in light of the comments received, ESMA kept the option 1 in the final advice. However, ESMA felt necessary to import some elements of the option 2 in the final advice to make it slightly more specific.

Q68: Do you think ESMA should be more specific on how the risk management system should be disclosed to investors? If yes, please provide suggestions.

532. The vast majority of respondents did not feel necessary for ESMA to be more specific on how the risk management system should be disclosed to investors.

533. It was proposed to delete the reference to ‘anticipated impact’ on investors in paragraph 6 because the AIFM would not be in a position to make that judgement.

ESMA’s response: Based on the feedback received from the consultation, ESMA did deem necessary to be more specific on how the risk management system should be disclosed to investors.

Possible implementing measures on reporting obligations to competent authorities.

Box 109

534. According to some respondents, ESMA should take into the account the need to minimise the administrative burden on competent authorities arising out of the transparency requirements of the Directive. Therefore, some respondents were of the view that information required by paragraph 1, 3 and 6 should be provided by an AIFM on an annual basis, other than in the case of the very limited number of AIF whose activities and size are such that they might be deemed to have the potential to be systemically significant, in which case quarterly reporting may be reasonable. For this purpose, it was proposed that a benchmark for possible materiality be set at 3 billion of euros.

535. It was also pointed out that the timescale should be determined by reference to the financial year of the AIF rather than a reference to calendar year otherwise competent authorities would be swamped with information.

536. Information required under paragraphs 1(a) and 1(b) was felt not to be appropriate for non-listed real estate funds that do not generally invest in financial instruments. Furthermore, some concern was expressed about paragraph 3(d) (ii) that requires information on the terms of financing provided by counterparties to the AIF which usually are of confidential nature.

ESMA’s response: As explained in the question 69 below, ESMA has modified in the final advice the approach concerning the reporting frequency but did not feel necessary to amend the information requested.

Q69: Do you agree with the proposed frequency of disclosure? If not, please provide alternative suggestions.

537. The vast majority of respondents disagreed with the proposed frequency of disclosure. For several respondents, reporting requirements should be on an annual basis while an approach based on the size of the AIFM was also proposed.

538. Paragraph 5 of Box 109 raised also some concerns among stakeholders that felt it could lead to significant disparity of treatment across the EU and market distortions.

ESMA’s response: In light with the comments received, ESMA moved away from the quarterly reporting as proposed in the public consultation. Indeed, ESMA acknowledges that it may not be appropriate to

require systemically all AIFM to report on a quarterly basis. Therefore, ESMA recommends in Box 109 a reporting frequency which is based on the total of assets managed by the AIFM, the size of the AIF itself and the investment strategy.

Q70: What costs do you expect completion of the reporting template to incur, both initially and on an on-going basis? Please provide a detailed analysis of cost and other implications for different sizes and types of fund.

539. Respondents to the consultation were generally anticipated that the ESMA's proposal would create additional costs (initial and on-going) without being able to provide with any estimation. Respondents also stressed that the costs would vary across the different types of AIFs.

Q71: Do you agree with the proposed reporting deadline i.e. information to be provided to the competent authorities one month after the end of the reporting period?

540. Most of the respondents to the consultation disagreed with the reporting deadline and asked ESMA to consider the possibility for a 4-month or 3-month reporting deadline.

ESMA's response: ESMA strongly believes that the reporting deadline should be kept to one month otherwise the information received by competent would no longer be up-to-date which would be detrimental for the monitoring of systemic risk.

Q72: Does ESMA's proposed advice in relation to the assessment of whether leverage is employed on a substantial basis provide sufficient clarity to AIFMs to enable them to prepare such an assessment?

541. For several respondents the ESMA's approach was too subjective and would be interpreted differently by national competent authorities. According to them, ESMA should be more specific with more objective criteria.

542. Some stakeholders indicated that they would appreciate an indication of a 'safe harbour' below which an AIFM would not be considered as employing leverage on a substantial basis and proposed that the limit could be set a level of 100% of the AIF's capital. One respondent agreed with ESMA's suggestion to use a self-assessment approach.

Reporting Template (Annex V):

On the reporting template, ESMA received a limited number of comments which are summarised below:

- Section 1 (1) : under the proposed format, the funds that do not pursue an alternative strategy, which can be very numerous as mentioned above, will be mingled in an 'other funds' category including as well infrastructure and commodity funds as well as an 'other' category. Why funds with such different profiles are mixed?
- Section 1(3) individual exposures per categories of instruments: A category of cash and cash equivalent (for money market funds) should be added as well as a category 'other assets' under point c) real assets (for assets such as art, wine etc.).

- Section 1(3) typical deal size: the type of information required should be clarified.
- Section 1(4): why the G10 bonds are split per maturity and not the Non-G10 bonds? One respondent would also suggest considering the distinction between ‘investment grade’ and ‘non-investment grade’ similarly as for the corporate bonds, as it do not understand the relevance of the distinction between G-10 and Non G-10.
- Section 1(4), value of turnover: Formula for calculating turnover should be defined to order to allow consistency in the reporting. Turnover on money market instruments and derivative is usually not a relevant information as it is a direct consequence of the roll forward of short term positions. EFAMA would then suggest removing these from the reporting.
- Section 2(6): If the fund is distributed through intermediaries (for instance, retail funds, feeders, funds of funds...), this information will not necessarily be accessible and the AIFM might not be in a position to report.
- Section 3(9): AIFM should not be required to disclose ‘expected’ return and risk profiles to regulators. Such disclosure would be pure conjecture.
- Section 3(9): The category ‘infrastructure fund’ mentioned here is not included as a category per say under question 1. As this section focuses on typical ‘hedge fund’ risks, all fund categories other than hedge funds (for instance the unleveraged funds invested in listed securities as mentioned above) should be exempted from this section. Indeed, expected return cannot be assessed upfront for traditional funds taking long position on the markets as the return will largely derive from the beta.
- Section 3(c): Liquidity profile is not relevant for closed-end funds. They should be exempted from this reporting.
- Section 3(18) (i): If the fund is distributed through intermediaries (for instance, retail funds, funds sold through feeders, funds of funds, structures...), this information will not necessarily be accessible and the AIFM might not be in a position to report.
- Section 3(18)(i): The category ‘other funds of funds’ will mix up alternative and non-alternative strategies. Will this information be useful?

ESMA’s response: With regards Section 1, ESMA decided to add a new point 2) with the breakdown of strategies. This section will allow, AIFM which are managing AIF falling into the bucket ‘other’ to give a description of the strategy pursued by the AIF. The section on geographical focus has been detailed with further breakdown by regions.

543. Under the section Individual Exposure (Section 4), as requested by respondents, a new line on cash and cash equivalent has been added as well as a reference to Money Market Funds under the heading Collective Investment Undertakings (Section4 paragraph d).

544. Concerning the paragraph on ‘typical deal size’, it was clarified that this information should be given only for private equity funds.

545. ESMA acknowledges that information on Investor Concentration might be difficult to obtain in certain circumstances but if AIFM has access to it, it should be communicated to competent authorities. Concerning the information on Controlling Influence, it has been restricted to private equity AIF.

546. For the section on liquidity profile, a new question asking whether or not the fund provides investors with withdrawal / redemption right has been added to take into account closed-ended funds that do not offer such possibility to investors. Finally, the question on fair value has been deleted.

Feedback on consultation on ESMA's draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive in relation to supervision and third countries (ESMA/2011/270)

Equivalence

Criteria

547. Many respondents sought clarification on the criteria and approach for the equivalence assessment (e.g. should it be a detailed comparison between the third country legislation and all relevant EU Directives, or only the AIFMD? Should the focus be on the 'outcomes' of the third country law, instead of a line-by-line comparison (equivalence meaning equivalent effects)?). Others challenged the concept of equivalence itself, since during the AIFMD negotiation this was discussed and dismissed. Several respondents advocated, alternatively, the use of international standards as the appropriate benchmarks (with reliance on IMF FSAP) and, more generally, a less prescriptive principles-based approach. The general suggestion was to issue transparent and objective assessment criteria as soon as possible to allow third countries to make the necessary adjustments to their regulatory frameworks. More specifically, one respondent was of the view that the equivalence could cover 'operating conditions', since the AIFMD referred only to 'prudential regulation and supervision'.

548. ESMA's response: In light of the feedback to the consultation, ESMA considered it appropriate to replace references to 'equivalence' with 'to the same effect' in line with the Level 1 text. With respect to delegation of portfolio and risk management in particular, the notion of equivalence has been deleted entirely. This is in order to recognise the distinction at Level 1 between the requirements on third country depositaries, which explicitly envisage an assessment of the relevant regulatory framework, and those on delegation, which do not make provision for such an assessment.

Assessment process

549. According to some respondents, the implementing measures should provide for a clear methodology and procedure to assess equivalence. In order to avoid potential market disruption, the assessment should be conducted at the earliest possible opportunity and well before the commencement of the passport. For several respondents, ESMA should play a sufficient part in the overall process to ensure a level playing field. A dialogue with the relevant third country should be developed before any assessment.

550. ESMA's response: ESMA did not consider it appropriate to enter into the details of the assessment of the third country framework at this stage, on the basis that this would more appropriately be addressed via other measures and that some flexibility should be retained. ESMA is also conscious of the concerns over the timing of the establishment of the co-operation arrangements and will treat this as a high priority in view of the July 2013 deadline.

Independence of the regulator

551. A question was raised on how compliance with the IOSCO/Basel Principles would be measured (e.g. self-assessment, ESMA review or IMF FSAP). One respondent pointed out that a regulator assessed

as 'broadly compliant' should be deemed to satisfy the requirement (i.e. 'full compliance' should not be necessary). Another respondent maintained that this requirement of independence went beyond Level 1.

552. ESMA's response: ESMA considers the independence of the regulator to be a crucial element when assessing the third country framework. Given its importance, ESMA maintains its view that 'full compliance' with the criteria set out in Part II ('The Regulator') of the IOSCO Objectives and Principles for Securities Regulation and relevant Methodology, and the Basel Committee Core Principles and the relevant Methodology, should be required.

Delegation

553. Some respondents suggested it be clarified that, consistently with Level 1, the requirement for authorisation/registration applies only when the delegated function relates to portfolio or risk management.

ESMA's response: ESMA agreed with the suggestion and has clarified this in the final advice.

Depositary

554. For several respondents the advice should clarify that an entity not licensed as a credit institution or an investment firm may still be subject to supervision and prudential requirements that satisfy the Directive. Moreover, it was considered essential that investment activity is not restricted while the Commission is deliberating on the equivalence. Some respondents felt that the advice should recognise that in some jurisdiction (e.g. the US) the supervision of portfolio custody can involve multiple authorities. A suggestion was also made to replace, in par. 7 of Box 2 explanatory text, the word 'may' with 'shall', in order to clarify that the equivalence assessment has to be made by the Commission.

ESMA's response: ESMA has acknowledged in the final advice that an entity which is subject to prudential oversight and licensed under a local category other than as a credit institution or an investment firm may be assessed with a view to ascertaining whether the relevant local criteria have the same effect as those established under EU legislation for credit institutions and/or investment firms. ESMA has also made it clear that the Commission should (rather than 'may') issue decisions in this context.

Cooperation

On-site inspection

555. Concerns were raised in respect of allowing an EU competent authority to conduct its own regulatory inspections in a foreign country without qualifications; reciprocity should be ensured. According to one regulatory authority, a high frequency of on-site inspections on behalf of, and information exchanges with EU authorities, would result in significantly increased costs.

ESMA's response: ESMA has drafted its advice from the perspective of EU competent authorities and the rights that they should be granted on the basis of the co-operation agreements. The issue of possible reciprocity, if considered desirable by the third country authority, would be addressed during the discussions on the detailed content of the agreements.

Enforcement

556. Respondents requested more clarity on the respective responsibilities of the EU authorities and the third country regulators, since in their view a foreign regulator could not operate outside the remit of their national legislation and EU requirements could not apply outside the EU. It was stressed that the third country delegated entity and/or depositary applied local regulation on the assumption that the entity is regulated in its own jurisdiction; thus the enforcement should be only by the local regulator. Some respondents felt that the concepts of ‘breach of regulation’ and enforcement of ‘EU legislation’ were too broad and that the focus should rather be on breaches of the AIFMD.

ESMA’s response: As noted above, the detailed allocation of responsibilities between the authorities will be addressed during the negotiation of the co-operation arrangements; the advice focuses on the key principles to be taken into account. ESMA agreed with respondents’ proposals for clarification and has amended the advice to make clear that the breaches should be understood as relating to the AIFMD and its implementing measures.

Cooperation arrangements

557. There was broad support for reliance on existing internationally agreed standards on enforcement and supervisory co-operation. Many respondents also expressed support for the proposed multilateral approach and for the role of ESMA in centralising negotiations. Some highlighted that bilateral MoUs should be permitted, but only until the ESMA MMoU was finalised. Others believed that Member State competent authorities should not be precluded from negotiating bilateral arrangements (e.g. in connection with private placement regimes under Article 42). Some noted that the scope of the co-operation arrangements set out in the CP (supervision and enforcement) would go beyond the AIFMD (systemic risk oversight). Some respondents suggested that the principles of proportionality and non-duplication should be introduced in the co-operation arrangements. It was further noted that the language used in Box 3 would seem to be inconsistent with the fact that regulators cannot enter into legally binding obligations. One respondent underlined the desirability of adopting a non-discriminatory approach to the extent that a difference in time of approval may unfairly advantage those jurisdictions considered first. In this respect some industry associations offered to help establish a list of countries where the conclusion of MoUs was more urgent. Finally, for the large majority of respondents, the safeguards applicable in the case of the third country passport should be fixed as soon as possible, and be the same as those in Box 3 (to ensure a level playing field).

ESMA’s response: In light of the broad support expressed by respondents, ESMA has confirmed in the final advice its reliance on international standards. ESMA has also reiterated its preference for a centralised approach leading to the adoption of an MMoU covering all EU competent authorities. ESMA’s aim is to finalise such an MMoU in good time ahead of the deadline of July 2013 and in a manner that ensures fair treatment of all third country authorities. Finally, ESMA considered whether to make a distinction between the information to be provided for the purposes of systemic risk oversight versus for supervision and enforcement purposes. ESMA is of the view that systemic risk is sufficiently important to justify the exchange of the same level of information in both cases.

Systemic risk oversight

558. Some respondents suggested that the information sharing should be provided upon request, instead of continuously and in respect of each and every fund marketed in the EU.

ESMA's response: ESMA did not consider it appropriate to limit the information sharing to ad-hoc requests only on the basis that systemic risks could arise quickly and could be monitored more effectively if information was provided on a more regular basis.

Data protection

559. Some respondents raised concerns on par. 7 of the explanatory text under Box 3, as they felt it required that the third country regulator would ensure an adequate level of data protection within the meaning of Directive 95/46/EC, which would go beyond Article 52 of the AIFMD.

ESMA's response: In the final advice, ESMA has modified the relevant text so as to align it more closely with the requirements in Articles 51 and 52 of the AIFMD. ESMA is not seeking to go beyond the provisions on data protection as set out in those articles.

Cross-border marketing

Definition of effective marketing

560. While supporting ESMA's approach, several respondents sought guidance on the criteria to determine where effective marketing of most of the AIFs is conducted (e.g. number of investor targeted, frequency and visibility of advertisement, amount of assets raised). A list of non-exhaustive factors was generally deemed useful. It was noted that if the reference is to the majority of investors (number or value of investments), this figure would change over time; the criteria could rather refer to the presence of affiliates/distributors.

ESMA's response: ESMA agreed with the need to expand on the criteria to be taken into account when determining where the effective marketing of most of the AIFs takes place. These indicative criteria have been included in the revised explanatory text.

Procedural concerns

561. One respondent suggested the introduction of a non-objection procedure to the effect that the Member State of reference should automatically be the one designated by the AIFM unless reasoned objection is notified in writing by the relevant regulator within one month.

ESMA's response: ESMA took the view that such an approach would leave too much discretion for the AIFM and did not give sufficient recognition to the role of the competent authority in determining the Member State of reference.

Annex V

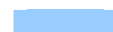

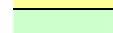
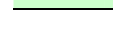
Pro-forma for AIFM Reporting to Competent Authorities (Article 24)

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		Q	Data Type	Reported Data
Lvl 1	Lvl 2			
Section 1 – Main Instruments Traded and Individual Exposures				
1	1a)	1	Predominate AIF type (select one)	[Select one] Hedge Fund Private Equity Fund Real Estate Fund Fund of Funds Other
1	1a)	2	Breakdown of investment strategies Provide a breakdown of the investment strategies of the AIF depending on the predominate AIF type selected in question 1. See guidance notes for further information on how to complete this question.	
			a) Hedge Fund Strategies (Complete this question if you selected ‘Hedge Fund’ as the predominate AIF type in question 1.) Indicate the hedge fund strategies that best describe the AIFs strategies	
			b) Private Equity Strategies (Complete this question if you selected ‘Private Equity’ as the predominate AIF type in question 1.) Indicate the private equity strategies that best describe the AIFs strategies	
			c) Real Estate Strategies (Complete this question if you selected ‘Real Estate’ as the predominate AIF type in question 1.) Indicate the real estate strategies that best describe the AIFs strategies	
			d) Fund of Fund Strategies (Complete this question if you selected ‘Fund of Funds’ as the predominate AIF type in question 1.) Indicate the ‘fund of fund’ strategy that best describe the AIFs strategies	
			e) Other Strategies	

AIFMD Ref		Q	Data Type	Reported Data		
Lvl 1	Lvl 2					
2 d)	3 e)		Of which are:	Investment grade		
				Non-investment grade		
1	1 a)		Sovereign bonds			
2 d)	3 e)		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)		Convertible bonds not issued by financial institutions			
2 d)	3 e)		Of which are:	Investment grade		
2 d)	3 e)			Non-investment grade		
1	1 a)		Convertible bonds issued by financial institutions			
2 d)	3 e)		Of which are:	Investment Grade		
2 d)	3 e)			Non-investment grade		
1	1 a)		Loans			
2 d)	3 e)		Of which are:	Leveraged loans		
				Other loans		
1	1a)		Structured/securitised products			
2 d)	3 e)		Of which are:	ABS		
				RMBS		
				CMBS		
				Agency MBS		
				ABCP		
				CDO/CLO		
				Other		
1 & 2d)			b) Derivatives		<i>Long Value</i>	<i>Short Value</i>
1	1 a)		Equity derivatives			
2 d)	3 e)		Of which are:	Related to financial institutions		
				Other equity derivatives		
1	1 a)		Fixed Income derivatives			
			CDS			
2 d)	3 e)		Of which are:	Single name financial CDS		
				Single name sovereign CDS		

AIFMD Ref		Q	Data Type	Reported Data	
Lvl 1	Lvl 2				
			Single name other CDS		
			Index CDS		
			Exotic (incl. credit default tranche)		
				<i>Gross Value</i>	
1	1 a)		Foreign exchange (for investment purposes)		
			Interest rate derivatives		
			Commodity derivatives	<i>Long Value</i>	<i>Short Value</i>
2 d)	3 e)		Of which are:		
			Crude oil		
			Natural gas		
			Gold		
			Power		
			Other commodities		
1	1 a)		Other derivatives		
1 & 2d)			c) Physical (Real / Tangible) Assets	<i>Long Value</i>	
1	1 a)		Physical: Real Estate		
			Of which are:		
			Residential real estate		
			Commercial real estate		
			Physical: Commodities		
			Physical: Timber		
			Physical: Art and collectables		
			Physical: Transportation assets		
			Physical: Other		
1 & 2d)			d) Collective Investment Undertakings	<i>Long Value</i>	
1	1 a)		Investments in CIU operated/managed by the AIFM		
			Of which are:		
			Money Market Funds and Cash management CIU		
			Other CIU		
1	1 a)		Investments in CIU not operated/managed by the AIFM		
			Of which are:		
			Money Market Funds and Cash management CIU		
			Other CIU		
1 & 2d)			e) Investments in other asset classes	<i>Long Value</i>	<i>Short Value</i>



AIFMD Ref		Q	Data Type	Reported Data	
Lvl 1	Lvl 2				
1	1 a)		Total Other		
1	1 a)	5	Value of turnover in each asset class over the reporting months		
			a) Securities		
			Cash and cash equivalents	<i>Market Value</i>	
			Listed equities		
			Unlisted equities		
			Corporate bonds not issued by financial institutions		
			Of which are:		
			Investment grade		
			Non-investment grade		
			Corporate bonds issued by financial institutions		
			Sovereign bonds		
			Of which are:		
			G10 bonds		
			Non-G10 bonds		
			Convertible bonds		
			Loans		
			Structured/secured		
			b) Derivatives		
			Equity derivatives	<i>Notional Value</i>	<i>Market Value</i>
			Fixed Income derivatives		
			CDS		
			Foreign exchange (for investment purposes)		
			Interest rate derivatives		
			Commodity derivatives		
			Other derivatives		
			c) Physical (Real / Tangible) Assets		
			Physical: Commodities	<i>Market Value</i>	
			Physical: Real Estate		
			Physical: Timber		
			Physical: Art and collectables		
			Physical: Transportation assets		

AIFMD Ref		Q	Data Type	Reported Data	
Lvl 1	Lvl 2				
			Physical: Other		
			d) Collective investment undertakings		
			e) Other asset classes		
1 & 2d)		6	Currency of Exposures		
			a) What is the reporting funds base currency?	<div style="border: 1px solid black; background-color: #e0f0ff; padding: 5px;"> [Select one] AUD CAD CHF EUR GBP HKD JPY USD Other </div>	
			b) Report the total long and short value of exposures (before currency hedging) by the following currency groups:		
			AUD	<i>Long Value</i>	<i>Short Value</i>
			CAD		
			CHF		
			EUR		
			GBP		
			HKD		
			JPY		
			USD		
			Other		
1 & 2d)		7	Typical deal/position size		
			(Complete this question if you selected as your predominate AIF type 'private equity fund' in question 1)	<div style="border: 1px solid black; background-color: #e0f0ff; padding: 5px;"> [Select one] Very small Lower Mid Market Upper Mid market Large Cap Mega Cap </div>	

AIFMD Ref		Q	Data Type	Reported Data						
Lvl 1	Lvl 2									
Section 2 – Most Important Concentrations										
Most Important Concentrations										
1	1 c)	8	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)	<input type="text"/> <input type="text"/> <input type="text"/>						
1	1 c)	9	Investor Concentration Specify the approximate percentage of the AIF's equity that is beneficially owned by the five beneficial owners that have the largest equity interest in the AIF (as a % of outstanding units/ shares of the AIF)	<input type="text"/>						
1	1 c)	10	Portfolio Concentration Top ten positions as a % of gross market value (GMV):	<input type="text"/>						
2(c)	2 (d)(ii)	11	Controlling Influence (Complete this question if you selected as your predominate AIF type 'private equity fund' in question 1) 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	<table border="1"> <thead> <tr> <th>Name</th> <th>% Voting Rights</th> <th>Transaction Type</th> </tr> </thead> <tbody> <tr> <td><input type="text"/></td> <td><input type="text"/></td> <td><input type="text"/></td> </tr> </tbody> </table>	Name	% Voting Rights	Transaction Type	<input type="text"/>	<input type="text"/>	<input type="text"/>
Name	% Voting Rights	Transaction Type								
<input type="text"/>	<input type="text"/>	<input type="text"/>								

Section 3 – Risk Profile of the AIF

a) Market Risk Profile

2(c)	3 (d)(i)	12	Expected annual investment return/IRR in normal market conditions (in %)	<input type="text"/>
------	----------	-----------	---	----------------------



AIFMD Ref		Q	Data Type	Reported Data
Lvl 1	Lvl 2			
2c)	3 (d)(i)	13	Net Equity Delta	<input type="text"/>
2c)	3 (d)(i)	14	Net DVo1 :	<input type="text"/>
2c)	3 (d)(i)	15	Net CSo1 :	<input type="text"/>
b) Counterparty Risk Profile				
2c)	3 (d)(i)	16	Trading and clearing mechanisms	
			a) Estimated % (in terms of market value) of securities traded: (leave blank if no securities traded)	%
			On a regulated exchange	<input type="text"/>
			OTC	<input type="text"/>
2c)	3 (d)(i)		b) Estimated % (in terms of trade volumes) of derivatives that are traded: (leave blank if no derivatives traded)	%
			On a regulated exchange	<input type="text"/>
			OTC	<input type="text"/>
2c)	3 (d)(i)		c) Estimated % (in terms of trade volumes) of derivatives transactions cleared: (leave blank if no derivatives traded)	%
			By a CCP	<input type="text"/>
			Bilaterally	<input type="text"/>
2c)	3 (d)(i)		d) Estimated % (in terms of market value) of repo trades cleared: (leave blank if no repos traded)	%
			By a CCP	<input type="text"/>
			Bilaterally	<input type="text"/>
			Tri-party	<input type="text"/>

AIFMD Ref		Q	Data Type	Reported Data																								
Lvl 1	Lvl 2																											
2c)	3 (d)(i)	17	Value of collateral and other credit support that the AIF has posted to all counterparties a) Value of collateral posited in the form of cash and cash equivalents b) Value of collateral posited in the form of other securities (excluding cash and cash equivalents) c) Value of other collateral and credit support posted (including face amount of letters of credit and similar third party credit support)?	<table border="1"> <tr><td></td></tr> <tr><td></td></tr> <tr><td></td></tr> </table>																								
2 c) & 4	3 (d)(i) & 4	18	Of the amount of collateral and other credit support that the reporting fund has posted to counterparties (in question 17): what percentage has been rehypothecated by counterparties?	<table border="1"> <tr><td></td></tr> </table>																								
2c)	3 (d)(i)	19	Top Five Counterparty Exposures (excluding CCPs) a) Identify the top five counterparties to which the AIF has the greatest mark-to-market net counterparty credit exposure, measured as a % of the NAV of the AIF. Counterparty 1 Counterparty 2 Counterparty 3 Counterparty 4 Counterparty 5 b) Identify the top five counterparties that have the greatest mark-to-market net counterparty credit exposure to the AIF, measured as a % of the NAV of the AIF. Counterparty 1 Counterparty 2 Counterparty 3 Counterparty 4 Counterparty 5	<table border="1"> <thead> <tr> <th><i>Name</i></th> <th><i>Total Exposure</i></th> </tr> </thead> <tbody> <tr><td></td><td></td></tr> <tr><td></td><td></td></tr> <tr><td></td><td></td></tr> <tr><td></td><td></td></tr> <tr><td></td><td></td></tr> </tbody> </table> <table border="1"> <thead> <tr> <th><i>Name</i></th> <th><i>Total Exposure</i></th> </tr> </thead> <tbody> <tr><td></td><td></td></tr> <tr><td></td><td></td></tr> <tr><td></td><td></td></tr> <tr><td></td><td></td></tr> <tr><td></td><td></td></tr> </tbody> </table>	<i>Name</i>	<i>Total Exposure</i>											<i>Name</i>	<i>Total Exposure</i>										
<i>Name</i>	<i>Total Exposure</i>																											
<i>Name</i>	<i>Total Exposure</i>																											
2c)	3 (d)(i)	20	Direct clearing through central clearing counterparties (CCPs)	<hr/>																								

Q	Data Type	Reported Data								
	<p>a) During the reporting period, did the AIF clear any transactions directly through a CCP?</p> <p>b) If you answered “yes” in 20(a), identify the top three central clearing counterparties (CCPs) in terms of net credit exposure?</p> <p>CCP 1 (leave blank if not applicable)</p> <p>CCP 2 (leave blank if not applicable)</p> <p>CCP 3 (leave blank if not applicable)</p>	<p>Yes No (if no, skip remainder of the question and go to question 21)</p> <table border="1"> <thead> <tr> <th>Name</th> <th>Value held</th> </tr> </thead> <tbody> <tr> <td></td> <td></td> </tr> <tr> <td></td> <td></td> </tr> <tr> <td></td> <td></td> </tr> </tbody> </table>	Name	Value held						
Name	Value held									

c) Liquidity Risk Profile

Portfolio Liquidity Profile

2c) 3 (d) (ii)

21	Investor Liquidity Profile Percentage of portfolio capable of being liquidated	<input type="text"/> 1 days or less <input type="text"/> 2 - 7days <input type="text"/> 8 - 30 days <input type="text"/> 31 - 90 days <input type="text"/> 91 - 180 days <input type="text"/> 181 - 365 days <input type="text"/> longer than 365 days
22	Value of unencumbered cash	<input type="text"/>

Investor Liquidity Profile

23	Investor Liquidity Profile Percentage of investor equity that can be redeemed (as % of AIF's NAV)	<input type="text"/> 1 days or less <input type="text"/> 2 - 7days <input type="text"/> 8 - 30 days <input type="text"/> 31 - 90 days <input type="text"/> 91 - 180 days <input type="text"/> 181 - 365 days <input type="text"/> longer than 365 days
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2c) 3 b)

24	Investor redemptions	
	a) Does the AIF provide investors with withdrawal / redemption rights in the ordinary course?	<p>Yes No (if no, skip remainder of the question and go to question 25)</p>
	b) What is the frequency of investor redemptions (if multiple classes of shares or units, report for the largest share class by NAV)	<p>[Select one] Daily Weekly Fortnightly Monthly</p>

AIFMD Ref		Q	Data Type	Reported Data	
Lvl 1	Lvl 2				
					Quarterly Semi Annual Annual Other
			c) What is the notice period required by investors for redemptions in days (report asset weighted notice period if multiple classes or shares or units) d) What is the investor ‘lock-up’ period in days (report asset weighted notice period if multiple classes or shares or units)		
2a) & 2c)	3 a)	25	a) As at the reporting date, what percentage of the AIFs NAV is subject to the following arrangements : Side pockets Gates Suspension of dealing Other arrangements for managing illiquid assets (please specify)		% of NAV [Type] [%]
2a) & 2c)	3 a)		b) 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 including those in question 25(a)? Special arrangements as a % of NAV		
2c)	3 a)		c) 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? d) If ‘yes’ to q 25(c) then please indicate all relevant preferential treatment: Concerning different disclosure/reporting to investors Concerning different investor liquidity terms Concerning different fee terms for investors Preferential Treatment other than that specified above		(Yes or No)
2c)	3 d) (i)	26	Provide the breakdown of the ownership of units in the AIF by investor group (as % of NAV of AIF assets)		

Q	Data Type	Reported Data
---	-----------	---------------

Financing Liquidity Profile

27 Financing liquidity

a) Provide the aggregate amount of borrowing by and cash financing available to the AIF (including all drawn and undrawn, committed and uncommitted lines of credit as well as any term financing)

b) Divide the amount reported in 27(a) among the periods specified below depending on the longest period for which the creditor is contractually committed to provide such financing:

1 days or less 2 – 7days 8 - 30 days 31 - 90 days 91 - 180 days 181 – 365 days longer than 365 days

d) Borrowing and Exposure Risk

4 & 2 c) 6 & 3 (d)
(i)

28 Value of borrowings of cash or securities represented by:

Unsecured cash borrowing:
Collateralised/secured cash borrowing – Via Prime Broker:
Collateralised/secured cash borrowing – Via reverse repo:
Collateralised/secured cash borrowing – Via Other:

29 Value of borrowing embedded in financial instruments

Exchange-traded Derivatives: Gross Exposure less margin posted
OTC Derivatives: Gross Exposure less margin posted

30 Value of securities borrowed for short positions:

Q	Data Type	Reported Data
31	Gross exposure of financial and/or legal structures controlled by the AIF as defined in Recital 78 of the AIFMD	
	<i>Financial and/or legal structure</i>	
	<i>Financial and/or legal structure</i>	
	<i>Financial and/or legal structure</i>	
	
32	Leverage of the AIF	
	a) Gross Method	
	b) Commitment Method	
	c) Advanced Method (where calculated and subject to notification)	
e) Operational and Other Risk Aspects		
33	Total number of open positions	
34	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	
	.	
	.	
	.	
	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	
	.	
	.	
	.	

2c) 3 (d) (i)

Q	Data Type	Reported Data
	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	
	d) Subscriptions over the reporting period	
	1st Month of Reporting Period	
	2nd Month of Reporting Period	
	.	
	.	
	.	
	Last Month of Reporting Period	
	e) Redemptions over the reported period	
	1st Month of Reporting Period	
	2nd Month of Reporting Period	
	.	
	.	
	.	
	Last Month of Reporting Period	



Sample Guidance for AIFMs when completing pro-forma

[This section is only a guide and is incomplete.]

Units of Measurement

Unless otherwise stated: values should be reported in thousands ('1000's) and in the currency chosen by the home regulator; securities should be reported at fair market values, derivatives at notional values and options as delta adjusted notional values.

Definitions

CCP	Central counterparties (or central clearing houses), such as LCH.Clearnet, ICE Clear Europe and Eurex Clearing.
EEA	The European Economic Area is comprised of the following member states: Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, United Kingdom, Norway, Iceland and Liechtenstein. Note that not all EEA countries are also Euro zone members.
Fund assets	This includes all share classes in the fund. It does not include separately managed accounts.
G10	The G10 is made up of 11 industrial countries: Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States.
Gross market value (GMV)	GMV is calculated as the sum of the gross positive market value of contracts held by the fund plus the gross negative market value of contracts with counterparties. GMV represents the cost that would have to be incurred if all the funds contracts held by the fund had to be replaced at market values existing, for the purposes of this Survey, at the data collection point date.
Investment grade	For these purposes, investment grade instruments are rated BBB- or higher by Standard & Poor's and/or Baa3 or higher by Moody's and/or BBB- or higher by Fitch. This corresponds to credit quality step 3 or above as regards the long term mapping of ECAIs' credit assessments to credit quality steps (see http://www.fsa.gov.uk/pubs/international/ecais_standardised.pdf)
Long market value (LMV)	Total value of long positions – physical, synthetic and delta-adjusted derivative exposure.

Non-investment grade	<p>For these purposes, non-investment grade instruments are rated below BBB- by Standard & Poor's and/or below Baa3 by Moody's and/or below BBB- by Fitch. This corresponds to credit quality step of 4 or below as regards the long term mapping of ECAIs' credit assessments to credit quality steps (see http://www.fsa.gov.uk/pubs/international/ecais_standardised.pdf)</p> <p>Any unrated bonds held by the fund should also be recorded as being non-investment grade for the purposes of this Survey.</p>
Qualifying hedge fund	<p>Any fund where:</p> <p>(a) the total of or part of the AUM is touched by the UK regulated firm, and</p> <p>(b) the total net asset value of all strategy assets globally (including all fund share classes, managed accounts and other assets managed on the same or a similar basis as the underlying fund, regardless of whether located in the UK or otherwise) is greater than US \$500m.</p>
Short market value (SMV)	Total value of short positions – physical, synthetic and delta-adjusted derivative exposure.
Strategy assets	This includes all share classes in the fund and also separately managed accounts and other assets managed on the same or a very similar basis as the underlying fund.
Systemic risk	A systemic risk is a risk which, if it crystallised without any form of intervention by the authorities, would mean a real likelihood of major rapid disruption to the effective operation of a core function of the financial system (and thence wider economic impact).
Total gross	<p>Means gross nominal or notional value of all deals concluded and not yet settled on the reporting date. For contracts with <i>variable nominal or notional principal amounts</i>, the basis for reporting is the nominal or notional principal amounts at the time of reporting.</p> <p>We realise that nominal or notional amounts outstanding in relation to derivatives generally do not represent actual amounts truly at risk, but from a systemic risk perspective they do provide a measure of market size and a reference from which contractual payments are determined.</p>
UCITS fund	Refers to net asset value of assets managed in UCITS funds. A UCITS fund is a collective investment scheme/undertaking which requires authorisation pursuant to the UCITS Directive.
Unencumbered cash	<p>We are treating 'cash' as comprising near cash excluding all commercial paper. Please treat unencumbered cash as the fund's 'cash' minus the sum of the following:</p> <ul style="list-style-type: none"> • cash transferred to a collateral taker pursuant to a title transfer arrangement;

	<ul style="list-style-type: none"> • cash covered by security arrangements requiring another party's consent prior to use by hedge fund manager (this could include fixed charges); • cash the subject of a floating charge to the extent and in the amount that borrowings from the relevant lender exceed collateral otherwise provided to that lender (so, for example, where you owe \$200m to Bank A, \$100m which is subject to a fixed charge and Bank A also has a floating charge against you relating to all monies owed, \$100m of cash would be subject to the fixed charge and \$100m of cash would be subject to the floating charge for the purposes of the survey); and • any balances on derivative transactions between you and third parties which are the subject of collateral arrangements (including undrawn amounts).
[Other...]	[Needs to be defined for guidance]

Notes to Questions

Q1 Predominate AIF type

Select the most appropriate investment fund type. Select one.

- Hedge Fund
- Private Equity Fund
- Real Estate Fund
- Fund of Funds
- Other Fund

Q2 Breakdown of Investment Strategies

Indicate which investment strategy best describes the AIFs strategies.

Select one primary strategy of the AIF. Select the primary strategy that best describe the reporting funds strategies, even if the descriptions do not precisely match your characterisation of those strategies. Primary strategy funds are likely to be consistently and predominately focused on one strategy – select this as the primary strategy – even though they may invest in other strategies. Multi-strategy funds are likely to be diversified across multiple strategies on a regular basis, with this diversification an explicit part of investment strategy.

For Hedge Fund, Private Equity and Real Estate AIF Types:

Also report the percentage of NAV represented by all strategies of the AIF. The percentage of NAV reported can be based on a good faith estimate of the percentage of the AIFs net asset value represented by all strategies of the AIF (both primary and secondary strategies). The strategies listed are mutually exclusive (i.e. do not report the same assets under multiple strategies) and the percentages should add up to 100%. When reporting the percentage of NAV breakdown, do not select multi strategy but instead allocate to the other strategies listed.

For example, a Private Equity AIF that has a solely venture capital focus, would select “Venture Capital” as the primary strategy and report 100% of NAV against this strategy. In contrast, an Hedge Fund AIF that has a multi-strategy involving ½ macro and ½ Equity Long/Short, would select “Multi-strategy hedge fund” as the primary strategy and then report 50% of NAV under “Equity Long / Short” and 50% under “Macro”.

We do not require a precise determination of the percentage of NAV by strategy, as this may prove excessively complicated. Instead please provide good faith estimate of investor NAV that is represented by each strategy.

If in your view the AIFs allocation among strategies is appropriately represented by the percentage of deployed capital, you may also provide this information. However, in this case you must still report the estimate for the percentage of NAV.

a) Hedge Fund Strategies

For “Hedge Funds”: select one primary strategy. Provide the percentage NAV represented by each strategy.

	Primary strategy (select one)	% of NAV	% of Capital (optional)
Equity: Long Bias			
Equity: Long / Short			
Equity: Market Neutral			
Equity: Short Bias			
Relative Value: Fixed Income Arbitrage			
Relative Value: Convertible Bond Arbitrage			
Relative Value: Volatility Arbitrage			
Event Driven: Distressed / Restructuring			
Event Driven: Risk Arbitrage / Merger Arbitrage			
Event Driven: Equity Special Situations			
Credit Long / Short			
Credit Asset Based Lending			
Macro			
Managed Futures / CTA: Fundamental			
Managed Futures / CTA: Quantitative			
Multi-strategy hedge fund		[Blank]	[Blank]

Other hedge fund strategy			
---------------------------	--	--	--

b) Private Equity Strategies

For “Private Equity Funds”: select one primary strategy. Provide the percentage NAV represented by each strategy.

	Primary strategy (select one)	% of NAV	% of Capital (optional)
Venture Capital			
Growth Capital			
Mezzanine Capital			
Multi-strategy private equity fund		[Blank]	[Blank]
Other private equity fund strategy			

c) Real Estate Strategies

For “Real Estate Funds”: select one primary strategy. Provide the percentage NAV represented by each strategy.

	Primary strategy (select one)	% of NAV	% of Capital (optional)
Residential real estate			
Commercial Real estate			
Industrial real estate			
Multi-strategy real estate fund		[Blank]	[Blank]
Other real estate			

d) Fund of Fund strategies

For “Fund of Funds”: select one primary strategy.

	Primary strategy (select one)
Fund of hedge funds	
Fund of private equity	
Other fund of funds	

e) Other strategies

For “Other Funds”: select one primary strategy.

	Primary strategy

	(select one)
Commodity Fund	
Equity fund	
Fixed income fund	
Infrastructure fund	
Other fund	

Q3	<p>Predominant Geographical Focus</p> <p>Provide a geographical breakdown of the investments held by the AIF, as a percentage of total NAV of the AIF. Exclude interest rate and foreign exchange derivatives from the numerator and denominator.</p> <p>Provide a good faith estimate of investor NAV that is represented by each geographical region. Include securities that do not have one predominate geographical focus within supranational / multiple regions. Percentages should sum to 100%.</p>
Q4	<p>Exposures</p> <p>[To be completed.]</p>
Q5	<p>Turnover</p> <p>Report the value of turnover over the reporting period as the sum of the absolute value of buys and sells that occur during the reporting period.</p> <p>For asset turnover this should be an estimate where such a record is not kept on an asset class basis. All transaction values for derivatives should be provided on a total gross notional basis except for options where premium should be used. In relation to derivatives, for the purposes of this question packages such as call-spreads may be treated as a single position (rather than as a long position and a short position).</p> <p>Please include synthetic exposures to single stocks (i.e. CFDs) in the ‘Listed Equities’ category. Other equity derivatives (i.e. single stock futures, options and equity swaps) should be included at Equity Derivatives category.</p>
Q6	<p>Currency of Exposures</p> <p>a) Base Currency of AIF Report the currency in which the fund is run for investment purposes (e.g. the currency in which risk, portfolio allocation reports are used for internal investment decisions).</p> <p>b) Long and Short Value of Exposures by Currency For exposures reported in Q4, report the total long and short value by currency (before any currency hedging).</p>

Q7	Typical deal / position size
	Answer this question only if the AIF type selected in question 1 is “private equity”. Select the deal / position size that the fund typical invests in, where the categories equate to:
	Very Small <€5m Small (€5m to < €25m) Low / mid market (€25m to < €150m) Upper mid market (€150m to < €500m) Large cap (€500m to <€1bn) Mega Cap (€1bn and greater)
Q8	[To be completed.]
Q9	[To be completed.]
Q10	[To be completed.]
Q11	[To be completed.]
Q12	[To be completed.]
Q13	[To be completed.]
Q14	[To be completed.]
Q15	[To be completed.]
Q16	[To be completed.]
Q17	[To be completed.]
Q18	[To be completed.]
Q19	Top 5 Counterparties (excluding CCPs) a) List your top five trading counterparties to which the AIF has the the greatest net counterparty credit exposure to.



b) 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 losses 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.

Q20 [To be completed.]

Q21 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%

Q22 [To be completed.]

Q23 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%

Q24 [To be completed.]

Q25 [To be completed.]

Q26 Investor breakdown of the AIF

Specify the approximate percentage of the reporting funds equity that is beneficially owned by the following groups of investors:

	% of NAV

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	
Sovereign wealth funds	
Other collective investment undertakings (e.g. fund of funds)	
Other types of investors	

Q27	<p>Financing liquidity</p> <p>a) Aggregate Borrowing and Cash Financing</p> <p>Include all drawn and undrawn, committed and uncommitted lines of credit as well as any term financing</p> <p>e) Financing term (% locked for):</p> <p>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%.</p>
Q28	[To be completed.]
Q29	[To be completed.]
Q30	[To be completed.]
Q31	[To be completed.]
Q32	[To be completed.]
Q33	[To be completed.]

Q34

Historical risk profile

a) Gross investment return or IIR

Report the monthly performance of net asset value of AIF's assets (% increase/ decrease) gross 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)].

b) Net investment return or IIR

Report 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)].

c) Change in NAV

Report 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).

d) Subscriptions

[To be completed.]

e) Redemptions

[To be completed.]

