MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

January 14, 2011

Via ESMA Website:

European Securities and Markets Authority
11-13 avenue de Friedland - 75008
Paris
France

Re: Managed Funds Association Response to Call for Evidence on Implementing Measures on the Alternative Investment Fund Managers Directive

Dear Sirs:

Managed Funds Association ("MFA")[1] welcomes the opportunity to respond to the Committee of European Securities Regulators' (hereinafter the European Securities and Markets Authority ("ESMA")) Call for Evidence on Implementing Measures on the Alternative Investment Fund Managers Directive (the "Call for Evidence"). Throughout the drafting process on the Alternative Investment Fund Managers Directive (the "AIFMD"), MFA engaged with EU policy makers in a thoughtful, constructive manner on a number of important issues, most notably the ability of third country managers and funds to market to EU investors. We welcome the opportunity to work with ESMA as it responds to the European Commission's (the "Commission") provisional request for technical advice as the Commission works to implement the provisions of the AIFMD.

In general, we support the dual national private placement and EU passport regimes approach taken in the AIFMD, and believe this compromise takes an intelligent approach to the oversight of third country fund managers in a manner consistent with the G-20 commitments. Though there are many issues that will need to be addressed by ESMA in its guidance to the Commission, we focus our comments in this initial letter on the following issues:

(1) the application of the AIFMD to non-EU alternative investment fund managers ("AIFMs") that have agreements with EU sub-managers;

[1] MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $1.7 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

(2) the determination of assets under management of an AIFM by reference to EU alternative investment funds ("AIFs") and EU investors;

(3) globally coordinated reporting requirements for AIFMs and the protection of proprietary information reported by AIFMs;

(4) developing a definition or definitions of leverage that will provide the most useful information to regulators and other market participants by accounting for factors such as the source and type of funding creating the leverage and the types of assets being leveraged; and

(5) provisions relating to non-EU AIFMs, including developing clear guidelines regarding cooperation agreements, the determination of an AIFM's Member State of reference, the standard of liability for a non-EU AIFM's "legal representative," and the ability of sophisticated parties to choose the law governing their contractual rights.

In addition, while the AIFMD relates to all types of alternative managers and funds, we will focus our comments in this letter on firms that are predominantly focused on managing hedge funds, as opposed to other types of AIF. We also intend to provide further comments to ESMA on additional issues as ESMA further develops its advice to the Commission.

QUESTION FOR THE CALL FOR EVIDENCE

Question: Which categories of investment manager and investment fund will fall within the scope of the Alternative Investment Fund Managers in your jurisdiction? Please provide a brief description of the main characteristics of these entities (investment strategies pursued, underlying assets, use of leverage, redemption policy etc).

MFA Response:

Many MFA members have global businesses, with offices located in jurisdictions around the world, including the EU. Their businesses are structured in a variety of ways, taking into account business and regulatory considerations, among other factors. Some MFA members are headquartered in the EU with affiliates in the U.S. or Asia, and as such are likely to fall clearly into the definitions covering EU AIFM. More than 80% of the alternatives industry, however, is headquartered outside the EU. Even though many of those firms invest in the EU, have EU investors in the AIFs they manage, and may have offices in the EU, the AIFMD wisely recognized that the oversight of non-EU AIFMs that are regulated primarily in other jurisdictions, should be considered separately.

A typical U.S.-headquartered manager may have affiliated entities located in the EU providing sub-management, marketing, research and/or other functions to the primary manager, or to an AIF managed by the primary manager. The EU-based affiliate will

likely have regulatory permissions under the Markets in Financial Instruments Directive ("MiFID") to arrange, deal in and manage investments. The primary investment manager will likely be U.S.-based and a registered investment adviser, subject to the supervision of the U.S. Securities Exchange Commission (the "SEC").

Because the AIFMD requires each AIF to have a single AIFM, it is important for ESMA and the Commission to develop clear guidance on which entity will be deemed the "AIFM" for purposes of the AIFMD, when there are multiple entities with responsibilities related to the AIF. A sub-manager by definition has authority over the AIF only as determined by the primary manager. In most cases a sub-manager has no contractual relationship (no investment management agreement) with the AIFs of the primary manager; the sub-manager's sole client is the primary manager. The primary manager delegates some limited investment management authority to the sub-manager in respect of certain AIFs managed by the primary manager. The parameters of the delegation may vary, but ultimately the discretion is subject to the authority of the non-EU primary investment manager. Accordingly, we suggest that the primary manager should be deemed the AIFM because the primary manager is the entity with ultimate responsibility for management of the AIF and national regulators should have the ability to continue to regulate EU based sub-managers of non-EU AIFMs under MiFID.

COMMISSION PROVISIONAL REQUEST FOR TECHNICAL ADVICE

Part I: General Provisions, Authorisation and Operating Conditions

Issue 1 b) – Thresholds – calculation, oscillation, obligations below thresholds

The Commission has requested advice from ESMA on how to calculate the value of assets under management by an AIFM. We believe that the calculation should be based on an AIF's net assets, which best reflects investor capital that is at risk, and not based on gross assets. Net assets, as calculated on an AIF's balance sheet and audited annually, are easily verifiable. Gross assets would be difficult for regulators to define and would be confusing for managers to calculate, which could lead to significant uncertainty for market participants. We further believe that calculation of assets under management should exclude certain assets that may be invested in an AIF alongside investors' assets, such as the AIFM's own funds.

We also encourage ESMA to consider advising the Commission to calculate assets under management for non-EU AIFM by including only those assets of EU-based AIFs and assets of non-EU based AIFs that are beneficially owned by EU investors. We believe that EU funds and EU investors should be the primary focus of EU regulators and, therefore, should be the relevant factor in determining whether an AIFM should be within the scope of the AIFMD. We note that this approach is similar to the one taken in the United States with respect to registration of foreign private fund advisers under the

Dodd-Frank Wall Street Reform and Consumer Protection Act[2] and the proposed rules by the U.S. SEC to implement that Act.[3]

Part III: Transparency Requirements and Leverage

Issues 20 to 25 (Transparency requirements)

MFA recognizes and supports regulators' need for information about the business activities of AIFMs and AIFs to conduct effective regulatory oversight of the industry and for purposes of analyzing the financial system as a whole. In connection with efforts to collect data from AIFMs and AIFs, regulators may receive data from and about AIFs and their investors that is proprietary and/or confidential. MFA's members expend significant time and resources to employ safeguards to preserve their trade secrets and protect the proprietary and/or confidential information of their investors and their private investments funds. While we respect and support the regulators' legitimate needs to collect such information, we are concerned about the harmful effects to investors and our members if such information were disclosed, reverse engineered or otherwise misappropriated. As a result, it is essential that regulators protect any such information that they receive in response to such surveys to the fullest extent permitted by law. We would thus encourage that, in its advice to the Commission, ESMA emphasize the need for the Commission to require that proprietary information of AIFMs and AIFs remain confidential.

In addition, as ESMA and the Commission both know, many regulators around the world are developing enhanced reports from private fund managers for regulatory oversight purposes and for the purpose of analyzing the financial system. As part of our support of the regulatory needs underlying these reports and requests for information, we have worked in a constructive manner with regulators to help them develop reports that are well designed to provide necessary information in an effective and efficient way. As part of those efforts, our members have provided regulators with requested data in response to survey requests, in the EU, the U.S. and Hong Kong. It is important to note that the scope and type of information that different regulators are requesting is not consistent and frequently does not reflect the ways in which managers currently keep information. Providing information to regulators pursuant to these surveys and reports requires fund managers to expend significant time and resources. As such, we suggest that ESMA and the Commission coordinate with other regulators to ensure that, to the extent possible, surveys and reports that are designed to achieve similar regulatory purposes are comparable and coordinated among regulators, consistent with the G-20 mandate. We further suggest that regulators provide respondents a sufficiently

[2] Sections 402 and 403 of the Act.

[3] See, Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, SEC Release No. IA-3111 (November 19, 2010), available at http://sec.gov/rules/proposed/2010/ia-3111.pdf.

reasonable period of time to comply and that regulators take into account current recordkeeping systems and methodologies, so that the information provided to regulators is consistent and useful and not burdensome for the firms to gather. We also encourage regulators to consider the extent to which requesting information from the prime brokers, exchanges, swap data warehouses and other market participants and utilities used by AIFMs may be a more effective or efficient way to gather and analyze information.

With respect to disclosures about remuneration, we note that the Committee of European Banking Supervisors (along with national regulators such as the U.K. Financial Services Authority (the "FSA")) has developed guidance in connection with the implementation of the recent amendments to the Capital Requirements Directive ("CRD III"), including guidance on disclosures related to remuneration practices. We encourage ESMA to use this guidance as a reference in developing its advice as to the remuneration disclosures that AIFMs should be required to make pursuant to the AIFMD.

Issue 19 – Article 4 Definition of leverage

The definition of leverage has significant implications as it will be relevant to a wide range of regulatory considerations, including regulation of over-the-counter derivatives and systemic risk monitoring and regulation. It is important for regulators to develop a definition or definitions of leverage that will provide the most useful information to regulators and other market participants by accounting for factors such as the source and type of funding creating the leverage and the types of assets being leveraged.

It is also important to base regulatory requirements relating to leverage on facts and not misperceptions of the use of leverage by hedge funds. Hedge funds are often mischaracterized as being highly leveraged financial institutions, when in fact the industry is, and has been, significantly less leveraged than other financial market participants. According to a recent Columbia University study, the leverage ratio of investment banks during the period from December 2004 to October 2009 was 14.2, with a peak of 40.7 for investment banks in 2009, and the leverage ratio of the entire financial sector during that period was 9.4.[4] By comparison, this study found that the leverage ratio for the hedge fund industry was 1.5 as of October 2009, with an average ratio of 2.1 from December 2004 to October 2009, and a high of 2.6. The findings of this study with respect to the leverage ratio of the hedge fund industry are consistent with other studies, including two recent studies by the FSA, which report leverage ratios below 3.0 for an extended period of time.[5]

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[4] Hedge Fund Leverage, available at: http://www2.gsb.columbia.edu/faculty/aang/papers/HFleverage.pdf.

[5] See, BofA Merrill Lynch study, which finds the leverage ratio for the industry was 1.16 as of July, 2010 http://www.reuters.com/article/idUSTRE67G28220100817; see also, FSA study, Assessing possible sources of systemic risk from hedge funds, July 2010 (finding a leverage ratio of 272% [2.72], as of April, 2010), available at: http://www.fsa.gov.uk/pubs/other/hedge_funds.pdf, and The Turner Review, A

Such leverage is generally obtained from large financial counterparties, including global banks and broker-dealers, that conduct substantial due diligence and engage in ongoing risk monitoring. Hedge fund borrowings are done almost exclusively on a secured basis (*i.e.,* secured by each fund's overall assets or specifically posted collateral), which limits the amount of leverage that any fund may obtain. This collateral posting by hedge funds reduces the credit exposure of counterparty financial institutions and makes hedge funds substantially less likely to contribute to systemic risk by causing the failure of a systemically important institution, such as a major bank. Given the limited leverage and the collateral posted by hedge funds, any losses that hedge funds incur are almost exclusively borne by their investors, not the general financial system. The "leverage" profile of a hedge fund is thus very different than that of other types of financial institutions, for example banks or principal dealers.

We believe that there are a variety of factors regulators should consider when determining whether leverage is used on a "substantial basis" and whether the use of leverage creates potential systemic risk concerns. Some of the factors that we encourage ESMA to consider in advising the Commission on the calculation of leverage, as well as the extent to which leverage should be regulated include:

- In considering leverage as a contributor to systemic risk, it is important to consider not only the aggregate amount of such leverage (inclusive of off-balance liabilities), but importantly the sources and terms of such leverage. Debt that is secured, for example, significantly mitigates systemic risk compared to debt that is unsecured. Similarly, short-term leverage (such as overnight borrowing) introduces greater risk than term borrowings, which more closely match the term of the asset and the financing which funds it. Finally, the degree of an investment fund's portfolio leverage must be considered in the context of its asset mix, including the liquidity of those assets, the liquidity rights of fund investors, as well as the size and nature of the capital markets in which those assets are transacted.

- Off-balance sheet exposures should be considered as part of determining overall leverage. However, the market value or risk of loss must be considered from a risk exposure perspective, as opposed to simply looking at notional values. Additionally, the nature of the instruments in question

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regulatory response to the global banking crisis, March 2009 (finding that the leverage ratio of the hedge fund industry since 2000 has been two- or three-to one), available at: http://www.fsa.gov.uk/pubs/other/turner_review.pdf.

The above studies use different formulas for calculating leverage ratios, which explains the slight differences in leverage ratios determined by each study. Our purpose in this letter is not to endorse any particular formula, but to demonstrate that the leverage ratios for the hedge fund industry are significantly less than the ratios for many other types of financial institutions.

and risk of loss must be considered. For example, a purchased option has substantially less risk than a sold option. Similarly, collateral arrangements, as well as offsetting positions across a portfolio (a hedge), must be taken into account.

- The ability of hedge fund managers to appropriately match the assets and liabilities of a fund (in light of the fund's leverage, sources of leverage, and equity capital stability) should prevent or mitigate the extent to which a fund is likely to become subject to a forced unwind and impact the broader securities market or financial system.

Part IV: Supervision

Issues 24 and 25 – Cooperation Agreements

As noted in the Call for Evidence, the text of the AIFMD does not provide guidance on the scope, objectives, or required parties for the cooperation agreements that must be entered into for third country AIFMs to be able to market to professional investors in the EU. We believe that it is important for the criteria established by the Commission be clear, to ensure consistent implementation across Member States. The U.S. SEC, which is the primary regulator for most U.S.-headquartered fund managers, has cooperation agreements in place with various EU Member State regulators and we suggest ESMA use those agreements as a reference when considering the appropriate scope of cooperation agreements under the AIFMD. We also suggest ESMA discuss the appropriate scope and content of cooperation agreements with regulators in other jurisdictions to promote a globally coordinated approach to such agreements and to ensure that regulators in other jurisdictions will be able to enter into the model cooperation agreement created by the Commission.

Systemic Risk Reporting

As discussed in the section on transparency above, MFA supports regulators having information about AIF for purposes of systemic risk assessment, provided that sensitive, proprietary information is kept confidential by regulators. In this regard we would ask that ESMA advise the Commission to take appropriate steps to ensure that such confidentiality be maintained. Because a number of regulators around the world request information from fund managers, we encourage ESMA to consider an internationally coordinated approach to such reports. A coordinated approach would likely be more valuable to regulators, as coordinated reports are more likely to produce data that can be compared across jurisdictions and would eliminate double counting of managers of funds, which will be critical to assessing the state of the financial system in a globally integrated marketplace. A coordinated approach would also be important to global fund managers, which are required to expend significant resources responding to requests for data. We also encourage regulators to consider the extent to which requesting information from the prime brokers, exchanges, data warehouses, and other

intermediaries or utilities used by AIFMs may be a more effective or efficient way to gather and analyze information.

Member State of Reference

Article 37(4)(h) of the AIFMD refers to the Member State of reference for an AIFM as "the Member State where [the AIFM] intends to develop effective marketing." It is unclear whether the Member State of reference would be based on the location of investors (or prospective investors), or whether it would be the Member State in which marketing activities are carried out (for example where a non-EU AIFM has an affiliate located in a specific Member State which carries out a marketing function). It is important for the criteria used to determine the Member State of reference promote consistency and certainty for market participants. We believe that criteria based on the location in which an AIFM's marketing activities are organized or carried out would provide clarity and certainty to market participants and to regulators. We believe that criteria based on the amount and location of offers to sell or prospective investors would be difficult to implement as market participants and regulators would likely have different interpretations of when an offer has been made and who is a prospective investor. We further believe that criteria based on the location of investors, while likely easier to implement than prospective investors, could lead to confusion and uncertainty for the AIFM as their regulator might change based on independent investment decisions taken by investors across many Member States. This risk of possible frequent changes as to an AIFM's Member State of reference (in particular the timing of such changes) would results in legal uncertainty for the AIFM and Member State regulators as well as unnecessary expense for AIFMs to determine the correct Member State of reference at any given point in time and de- and re-register as needed.

OTHER ISSUES NOT IN THE CALL FOR EVIDENCE

Non-EU AIFM's "legal representative"

Article 37 requires third country AIFMs that wish to market AIFs under the passport (once available to third country AIFMs) to have a "legal representative" in the AIFM's Member State of reference. The AIFMD does not address the responsibilities or potential liability for such a legal representative. This uncertainty would make it unlikely that an unaffiliated person would be willing to act as a legal representative. For AIFMs with no place of business in the Member State of reference, the inability to appoint an unaffiliated person as the manager's legal representative would effectively block access to the EU passport. An overly strict standard of liability for legal representatives likely would have the same consequence, as unaffiliated persons would be unlikely to assume such heightened risk. As such, we encourage ESMA to provide advice to the Commission establishing a clear and reasonable standard of liability for the legal representative of a third country AIFM. Because the legal representative follows the AIFM's Member State of reference, it will be important for there to be consistency among Member States on this issue.

Governing law and jurisdiction

Article 37(12) of the AIFMD provides that "any disputes between the AIFM or the AIF and EU investors of the relevant AIF shall be settled in accordance with the law of and subject to the jurisdiction of a Member State." As drafted, the wording could be interpreted to imply that *any* dispute between an AIFM and one of its EU investors would have to be settled in accordance with the law of a Member State, regardless of whether that dispute relates to a local EU regulatory issue or the interpretation of a provision under a fund subscription agreement (which has its own governing law clause). MFA recognizes that Member State regulators need the ability to protect investors, and we strongly support regulators having that authority. We believe, however, that sophisticated parties to a commercial contract, such as investors investing in AIFs, should have the right to choose the commercial terms governing that contract, including the choice of law to govern that contract. The freedom of parties to choose the governing law of a contract is well established, including under the Convention on the Law Applicable to Contractual Obligations 1980 (the Rome Convention). Accordingly, we encourage ESMA to consider limiting the application of this provision to investor protection and anti-fraud types of disputes and not to cover disputes over the terms of the subscription agreement.

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Conclusion

MFA appreciates the opportunity to provide comments to ESMA in response to the Call for Evidence. Implementation of the AIFMD is a significant issue for many of our members, and we are committed to participating in a constructive dialogue with ESMA and the Commission during the Level 2 implementation process.

If you have any questions regarding any of these comments, or if we can provide further information with respect to these or other issues in connection with Level 2 implementation of the AIFMD, please do not hesitate to contact Stuart J. Kaswell or me at (202) 367-1140.

Respectfully submitted,

/s/ Richard H. Baker

Richard H. Baker
President and CEO

Cc: Mr. Ugo Bassi, Head of Asset Management Unit, European Commission