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

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Via *ESMA Website*

European Securities and Markets Authority
103 Rue de Grenelle
75007 Paris
France

Dear Sir/Madam

Response to Public Consultation: ESMA's draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive (the "Directive") (the "Consultation Paper").

Managed Funds Association ("**MFA**")[1] welcomes the opportunity to provide comments to ESMA in response to its Consultation Paper.

MFA's responses are set out in the Annex to this letter. References to page numbers in the attached Annex are to the relevant pages in the Consultation Paper.

Throughout the drafting process on the Directive, MFA engaged with EU policy makers in a thoughtful, constructive manner on a number of important issues, most notably the ability of third party managers and funds to market to EU investors. We welcome the opportunity to work with ESMA as it prepares to respond to the European Commission's request for technical advice as the Commission works to implement the Level 2 provisions of the Directive.

MFA welcomes ESMA's general approach of using existing EU legislation and recognised international standards as the basis for preparing its recommendations on the Level 2 implementing measures set out in the Consultation Paper. MFA also supports ESMA's

[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 $1.9 trillion invested in absolute return strategies. MFA is headquartered in Washington D.C., with an office in New York.

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recognition of the importance of proportionality in preparing its recommendations given the diverse and varied types of AIFMs and AIFs that the Directive seeks to regulate.

MFA would like to take the opportunity provided by the Consultation Paper to provide comments on a number of matters that MFA believe will assist ESMA in preparing final recommendations to the Commission that will better balance the need for effective regulation with the reality of existing market practices. Though there are many issues covered in this letter, MFA would like to highlight the following key points that it has raised in this letter:

(1) In relying upon existing concepts in the UCITS Directive and MiFID, ESMA should bear in mind that, as AIFMs deal with professional investors rather than retail investors, the provisions under MiFID and the UCITS framework which are aimed at protecting a wide range of investors (including retail investors) may not always be appropriate and should be adjusted accordingly. Amongst other things, AIFMs do not have the benefit of an EU passport for marketing to retail investors, and so the standards applied to AIFMs should not simply reflect those in UCITS.

(2) MFA encourages ESMA to consider whether its proposals result in requirements which exceed those set by the Directive, for example in relation to Box 13 (*Selection and appointment of counterparties and prime brokers*).

We would be very happy to discuss our comments or any of the issues raised in the Consultation Paper with ESMA. If ESMA has any comments or questions, please do not hesitate to contact Benjamin Allensworth or the undersigned at +1 (202) 730-2600.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell

Executive Vice President &
Managing Director, General Counsel

ANNEX

MFA RESPONSES TO ESMA CONSULTATION OF 13 JULY 2011

ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE

III. ARTICLE 3 EXEMPTIONS

III.I Identification of the portfolio of AIF under management by a particular AIFM and calculation of the value of assets under management (p.17)

Question 1: 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?

Question 2: Do you think there is merit in ESMA specifying a single date, for example 31 December 2011 for the calculation of the threshold?

Question 3: 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.

Question 4: 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?

Question 5: Do you agree that AIFs which are exempt under Article 61 of the Directive should be included when calculating the threshold?

MFA General Response

MFA welcomes ESMA's view that AUM calculations should be based on NAV; however depending on when the NAV was calculated, MFA considers that the AIFM should be given the flexibility to determine, on an ongoing basis, change in value on a mark-to-market basis.

MFA believes that AUM for non-EU AIFMs should be calculated by including only: (1) EU AIFs; (2) assets of non-EU AIFs beneficially owned by EU investors; and (3) assets managed by EU based persons (EU based sub-investment managers). MFA considers that these three categories 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 full regulatory framework created by the Directive. We note that the United States has taken a similar approach 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. Securities and Exchange Commission (the "**SEC**") to implement that Act, as explained in the following paragraph.

Section 203(m) of the Investment Advisers Act of 1940 (the "**Advisers Act**") provides an exemption from registration for advisers only to private funds with less than $150 million in assets under management in the US. Under the SEC rule to implement this exemption, a non-U.S. adviser that does not have its principal place of business in the US may rely on this exemption provided that it does not have any U.S. clients that are not private funds and it

[2] Sections 402 and 403 of the Dodd-Frank Act.

manages less than $150 million in U.S. private fund assets at a place of business in the U.S. The SEC explained granting this exemption to non-U.S. advisers in its adopting release, stating "The rule reflects our long-held view that non-U.S. activities of non-U.S. advisers are less likely to implicate U.S. regulatory interests and that ***this territorial approach is in keeping with general principles of international comity***."[3] (Emphasis added) Non-U.S. advisers relying on this exemption are not required to register with the SEC, however, they do have to file certain reports with the SEC and they are subject to the anti-fraud provisions of the Advisers Act as well as SEC examinations.

MFA recognizes and supports the need for regulators to have appropriate oversight over market participants, including private fund managers. It is important, however, to ensure that the regulation of private fund managers is accomplished in a way that is consistent with the G-20 commitment to international coordination and, as noted above, the principles of international comity. We believe that the approach described above would effectively achieve the G20 goal of regulating private fund managers in a manner that avoids inconsistent or unnecessary overlapping regulation, both of which impede flows of capital.

As a technical matter, MFA would like ESMA to clarify whether the AUM test that it intends to apply for the purposes of the threshold limit in Article 3(2) will be the same as used when determining "the value of the portfolios of AIFs managed by the AIFM" under Article 9(3) (for the purposes of calculating initial capital, own funds and professional indemnity insurance requirements). MFA notes that paragraph 14, page 37 of the Consultation Paper makes reference to AUM as being the value of the portfolios of AIF managed by the AIFM, but there is no explicit cross-reference to the term AUM in respect of Article 3(2).

III.II Influences of leverage on the assets under management (p.23)

Question 6: 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?

No, MFA respectfully does not agree. Net assets under management, not gross assets, best reflects investor capital that is at risk. Net assets, as calculated on an AIF's balance sheet and audited annually, are easily verifiable. Gross assets, including when calculated using the Gross Method set out in Box 95, can lead to confusion and significant uncertainty for market participants given the different ways the elements of Box 95 could be calculated.

As a separate matter, MFA believes 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.

[3] SEC Release No. IA-3222, Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers (June 22, 2011).

Question 7: Do you consider that valid foreign exchange and interest rate hedging position should be excluded when taking into account leverage for the purposes of calculating the total value of assets under management?

We are unclear as to what is meant by "excluded" in this context. However, we would reiterate the point made earlier that net positions (taking into account all hedging and netting) should be used in any calculation of exposure and of leverage of an AIF. Thus valid foreign exchange and interest rate hedging position should be used to reduce the exposure for purposes of calculating assets under management.

In the event that a Gross Method exposure calculation is employed, any positions implemented to mitigate foreign exchange or interest rate risk from investments in the AIF's portfolio should not be included in the calculation of gross exposure. For example, if a USD denominated AIF holds 100mm of EUR denominated bonds and has also sold 100mm EUR forward to receive USD, this transaction should only have an exposure of the 100mm EUR converted to USD at the relevant foreign exchange rate. Similarly, if an AIF holds a portfolio of corporate bonds and has sold US Treasuries as an interest rate hedge, including both the corporate bonds and Treasuries will overstate the AIF's gross exposure. In this example, the Treasuries protect the AIF from adverse movements in interest rates which will impair the valuation of the corporate bonds, and as a result reduce overall portfolio risk.

Question 8: 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?

MFA considers that more clarity is required as to what constitutes "assets acquired through leverage". MFA believes that, given the many different forms of leverage that can be employed, the determination of assets "acquired through leverage" should be left to the reasonable determination of the relevant AIFM, so long as the AIFM is able to justify its calculation.

Paragraph 2 in Box 2 states that: "AIFMs shall calculate leverage using the Gross Method of calculating the exposure of the AIF as set out in Box 95." The Gross Method is not an indicator of leverage, so we assume what ESMA means is that leverage is to be calculated as set out in Box 93 (*i.e.* an AIF's exposure divided by its NAV) and that the AIF's exposure is calculated using the Gross Method. If so, then MFA does not agree with this approach. As noted above, we believe that net assets should always be the test. In this regard we do not see why the Advanced Method (or any other method available under the UCITS regime) should not be available in this context. Please see our further comments on this issue under our response to Q55-60.

IV. GENERAL OPERATING CONDITIONS

IV.II Possible Implementing Measures on General Principles (p.41)

MFA General Comment on Implementing Measures on General Principles

MFA welcomes the use, where appropriate, of MiFID and UCITS principles as the basis for AIFMD general principles and the high-level nature of these general principles. However, MFA believes that ESMA should always be mindful that, as AIFMs deal with professional investors rather than retail investors, the provisions under MiFID and the UCITS framework which are aimed at protecting a wide range of investors (including retail investors) should be adjusted accordingly.

By way of example, Box 13 imposes a requirement on AIFMs to exercise due skill, care and diligence in selecting and appointing "counterparties and prime brokers". MFA notes that Article 14(3) of the Directive applies such a diligence requirement on the AIFM only in relation to the appointment of prime brokers, and not counterparties generally. ESMA defines "counterparty" in this context to mean "a counter-party of an AIFM in an OTC transaction, in a securities lending or in a repurchase agreement" and requires that such counterparties (as well as prime brokers) be chosen only where they are "subject to ongoing supervision by a public authority".

This requirement in Box 13 goes beyond what the Directive provides. There may be situations where the relevant counterparty in an OTC derivative transaction is not regulated by a public authority but is nonetheless entirely appropriate as a counterparty. For example, SPVs are not subject to regulation even though they may be counterparties for AIFs; in addition not all derivatives dealers (particularly outside of the EU) are necessarily subject to regulation. The fact that an entity is unregulated does not necessarily mean that it is not appropriate as a counterparty to a transaction; conversely, it should not be assumed that a counterparty is appropriate simply because it *is* regulated. That is, the regulatory status of an entity is not dispositive of its suitability as a counterparty. AIFMs operate in the institutional arena and are able to make determinations as to which counterparties to deal with; in demonstrating that it has exercised due skill, care and diligence, an AIFM should not be required to make decisions based simply on the regulatory status of the potential counterparty.

MFA believes Box 13 should be deleted or at the very least amended to remove references to "other counterparties".

Question 16: Paragraphs 4 and 5 of Box 11 (p. 43) 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?

MFA has no comment on this question.

Question 17: Do you agree with Option 1 or Option 2 in Box 19? Please provide reasons for your view.

MFA prefers Option 2 in Box 19 in respect to determining fair treatment by an AIFM and concurs with ESMA that a less restrictive definition is needed in order to ensure flexibility and proportionality.

IV.III Possible Implementing Measures on Conflicts of Interest (p.55)

MFA General Comment on Conflicts of Interest

MFA welcomes ESMA's high-level approach to the principles when implementing conflicts of interest procedures and the flexibility this gives to AIFMs to adopt the most appropriate procedures and policies.

IV.IV Possible Implementing Measures on Risk Management (p.63)

MFA General Comment on Risk Limits in Box 29 (p.72)

MFA notes that, while the Directive requires that AIFMs implement adequate risk management systems, ESMA's proposal in Box 29 is very specific on risk limits. The level of specificity goes beyond what is required under the Directive and even goes beyond what is required under the UCITS framework. Given that UCITS investors are retail investors while AIF investors are generally institutional investors, MFA is of the view that the risk limit proposals for AIFMs should be *less*, rather than more, prescriptive than those for UCITS.

As a general matter, MFA considers market risk to be the main focus of an AIFM's risk policy and would favour a less prescriptive and more principles-based approach to identifying other types of risk that may need to be included in an assessment of the risk limits. In particular, it is not clear what limits on operational risk (paragraph 2(e), Box 29) can be assessed in an AIFM, particularly for small AIFMs. AIFMs should thus be given the flexibility to consider risks which are of particular relevance, rather than the "tick the box" approach that apparently is contemplated in relation to items (a) to (e) of paragraph 2 in Box 29.

Question 18: 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?

MFA has no comment on this question.

Question 19: 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?

Although MFA recognises that the Directive requires the functional and hierarchal independence of the risk management function from the operating units (including portfolio management) of the AIFM, MFA believes that portfolio management neither can nor should be entirely separated from risk management. Appropriate management of market risk, portfolio risk, liquidity risk, etc. requires the active involvement of portfolio management personnel. Portfolio managers have a significant and integrated role in monitoring and managing the risk. Moreover, portfolio management requires the use of appropriate risk analytics. We believe there should be a balance that allows for appropriate participation of portfolio management personnel.

MFA believes that "functional and hierarchal independence" does not preclude an AIFM having a risk management function that involves input (substantial or otherwise) from portfolio management personnel. Small or start up AIFMs may not have the resources to find additional staff to comply with a mandatory requirement to separate risk management from portfolio management, which will discourage new entrants to the market, thereby reducing overall employment opportunities in the industry and reducing choice for investors. Portfolio managers are naturally incentivised to identify and manage risk well – if they do not, investors will leave the AIF and the portfolio manager's reputation would be damaged. Moreover, portfolio managers frequently invest their own money in the AIFs they manage aligning their interests with the interests of investors when it comes to managing risk.

IV.V Possible Implementing Measures on Liquidity Management (p.76)

Question 20: 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?

MFA believes that liquidity management tools such as gates, whether imposed at the AIF level or at the investor level, and side pockets form part of the normal, dynamic liquidity management process for many AIFs. Given the large range of types of AIFMs and AIFs, it would not be appropriate to adopt a single principle whereby gates and side pockets may only be used in exceptional circumstances. Nor would it be appropriate to require that an AIFM demonstrate that circumstances are "exceptional" before being permitted to use such arrangements. Gates, for example, are needed where there is a sudden and significant numbers of requests for redemptions, in order to protect both redeeming and remaining investors in the AIF from being adversely affected if the AIF were required to complete a hasty disposal (at poor prices) of the AIF's assets.

AIF investors are professional investors; AIFs are not generally sold to retail investors. AIFMs do not have the benefit of the freedom under the UCITS Directive to market to retail investors and should not be subject to restrictions which address liquidity management concerns that might be valid in the UCITS context but which do not arise in the AIFM/AIF context.

As professional investors, AIF investors are in a position to determine the risk in investing in AIFs that may use such liquidity management arrangements and are generally familiar with the operation of such arrangements. MFA is of the view that, provided there is clear disclosure of the use of special arrangements, such as gates and side pockets, to investors in the AIF's documentation, then AIFMs should be able to use these methods as part of its normal liquidity management policies. As a general matter (not restricted to this response on liquidity management), we would point ESMA to the Frequently Asked Questions produced by the European Commission on 29 April 2009 (MEMO/09/211) stating what the (at that time proposed) Directive should not do: "Regulation of investment policies would be unnecessarily restrictive given the professional nature of the investor base and would be impractical to implement given the diversity of business models."

Question 21: 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?

Subject to our comment as to gates, side pockets, etc. not being restricted to "exceptional circumstances", MFA supports ESMA's proposals to combine a principles-based approach with disclosure in respect of the tools and arrangements that an AIFM considers are necessary or advisable to manage the liquidity risk of its AIFs.

Question 22: Do you agree with ESMA's proposed advice in relation to the alignment of investment strategy, liquidity profile and redemption policy?

MFA considers that the high-level approach reflected in ESMA's proposals for liquidity management are broadly appropriate. AIFMs often manage the liquidity of the investment portfolios of their AIFs over a period of time, usually several years, and seek to manage the general liquidity profile of the portfolios in a manner that is consistent with the obligations of the respective AIF over time, though this is not necessarily the same as matching the liquidity of the AIF to its obligations. An overly rigid requirement to match an AIF's redemption terms to the liquidity of its investment portfolio would unduly restrict the investment options for AIFMs. For example, an AIFM may be required to hold excess levels of cash and cash equivalents in the portfolio to hedge against possible redemptions and the possibility that unexpected market events may change the liquidity profile of the AIF's investments, leaving the portfolio less than fully invested which may adversely affect the risk/return profile that investors expect from the AIF.

V. DEPOSITARIES

V.I Appointment of a depositary (p.138)

1.1 Contract evidencing the appointment of a depositary

1.2 Particulars of the contract appointing the depositary

1.3 ESMA's justification for not providing a model agreement

MFA General Comment on a Model Agreement

MFA agrees with ESMA that no model agreement should be required to be used by industry; AIFMs and depositaries should be free to negotiate their own preferred terms.

V.III Depositary Functions

1.1 Cash flow monitoring (p.147)

1.2 ESMA's justification for not providing further guidance in relation to depositary's duties regarding subscriptions in the AIF (p.151)

1.3 Ensuring the AIF's cash is properly booked (p.152)

Question 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?

MFA considers that it would be difficult and indeed impractical to comply with such a requirement and that flexibility should be maintained as to where accounts can be opened. In particular, for non-EU AIFM's managing non-EU AIFs, although the depositary will have to be located either in the domicile of the non-EU AIF or in the Member State of reference of the non-EU AIFM, such a non-EU AIFM is unlikely to want to change its existing account structures where the AIF's accounts are at banks which may be located elsewhere *e.g*. in the U.S. Moving accounts from such banks to the depositary would be inefficient, costly, time consuming and unlikely to deliver any real benefit or protection to investors. AIFMs may operate several different types of accounts for their AIFs (operational cash accounts, cash management accounts, prime brokerage accounts, *etc*.) and also have different ways in which subscriptions are handled. Accounts may be with different institutions, which reduces concentration risk and which is thus beneficial to AIF investors. MFA considers that the proposal would increase costs on an ongoing operational basis, be of no real benefit to AIFs or their investors and may in fact increase concentration risk in a single institution as a result.

Question 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?

MFA has no comment on this question.

Question 27: Are there any practical problems with the requirement to refer to Article 18 of MiFID?

MFA has no comment on this question.

Question 28: Does the advice present any particular difficulty regarding accounts opened at prime brokers?

Yes, as noted in MFA's response to Q25, non-EU AIFMs in particular (who are more likely not to rely solely on the depositary) will be particularly affected by account structures which are more cumbersome and do not reflect existing market practice. Where accounts may be opened at prime brokers directly, MFA's view is that requiring accounts to be moved from existing prime brokers to the depositary are unlikely to benefit or protect investors, and may in fact increase risks to investors, and would likely be a costly and time-consuming exercise.

Question 29: Do you prefer option 1 or option 2 in Box 76? Please provide reasons for your view.

MFA considers that Option 1 (where the depositary acts as a central hub in respect of all information regarding cash flows) would be problematic and would likely cause delays in the subscription process. In addition, the proposal to mirror transactions is impractical, particularly for those AIFs engaging in systematic trading where a large number of transactions may be entered into in a very short time. MFA recommends Option 2 (where the depositary's role is to verify the procedures regarding the monitoring of cash flow and ensuring they are effectively implemented) be used to avoid the potentially burdensome and costly process under Option 1 but still ensure that the depositary still has sufficient information and oversight of the cash flow of an AIF.

Question 30: What would be the estimated costs related to the implementation of option 1 or option 2 of Box 76?

MFA's understanding from discussions with counterparties which may be depositaries indicates that the costs of establishing a bespoke system to mirror transactions are so prohibitive as to make it uneconomic for many institutions to carry on that role. This will in turn reduce the number of depositaries available and concentrate risk in the few institutions which may be able to design and implement such a system.

Question 31: What would be the estimated costs related to the implementation of cash mirroring as required under option 1 of Box 76?

MFA has no comment on this question.

V.III Depositary Functions

2.1 Definition of financial instruments that should be held in custody (p.155)

Question 32: Do you prefer option 1 or option 2 in Box 78 (p.155)? Please provide reasons for your view.

MFA prefers Option 2 in Box 78.

Option 1 places the depositary in a situation where it may be held liable for financial instruments may be registered or held in an account in its name, but in fact the depositary does not have control over title in those instruments, for example where another person has the right to give directions in relation to those instruments (including transferring them to another account).

Option 2 is preferable because it would tie the depositary's liability to situations where the depositary actually has power to instruct the transfer of title. However, MFA does not understand what is meant by the words "which acts directly for the issuer or its agent" at the end of Option 2; it is difficult to see how a securities settlement system can be described as acting "directly for the issuer or its agent". MFA thus recommends that those words be deleted.

Question 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?

MFA has no comment on this question.

Question 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?

In determining whether financial instruments provided as collateral should not be held "in custody" under Article 21(8)(a) of the Directive (which has a direct bearing on the liability standards imposed Article 21(12)), it is important that ESMA proposes a regime that is clear and workable in practice for depositaries and their clients the AIFs.

In this context MFA supports Option 3. Option 1 is not appropriate because it excludes any situation where collateral is granted by way of security (as opposed to by title transfer). Option 2 is potentially workable but MFA is concerned that the concepts of "control" or "possession", even under the Financial Collateral Directive, are not entirely clear.

2.2 Conditions applicable to the depositary when performing its safekeeping duties on each category of assets (p.159)

Question 35: How do you see the delegation of safekeeping duties other than custody tasks operating in practice?

MFA has no comment on this question.

Question 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?

MFA has no comment on this question.

Question 37: To what extent would it be possible/desirable to require prime brokers to provide daily reports as requested under the current FSA rules?

MFA is supportive of the suggested approach of requiring all prime brokers to include a disclosure annex with each prime brokerage agreement to summarise the key re-hypothecation provisions in each prime brokerage agreement and requiring daily reporting regarding client assets as currently imposed by the UK FSA (in section 9 of the FSA's Client Assets Sourcebook). MFA encourages ESMA to develop its suggestion along similar lines in order to boost transparency, with the disclosure annex required to be included with each prime brokerage agreement summarising the definitions of the agreement relevant to rehypothecation and daily reporting (in respect of the previous end of day position) based on the prime broker's books and records to be made available to AIFMs or AIFs.

Question 38: What would be the estimated costs related to the implementation of option 1 or option 2 of Box 81? 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?

MFA believes that Option 2 (mirroring all transactions) would be an expensive undertaking for depositaries and are concerned that the costs of the depositary framework will simply be passed on to AIFs, to the detriment of investors. We therefore prefer Option 1.

Question 39: To what extent does/should the depositary look at underlying assets to verify ownership over the assets?

MFA has no comment on this question.

3. Depositary functions pursuant to §9 – Oversight duties

Question 45: Do you prefer option 1 or option 2 in Box 86? Please give reasons for your view.

MFA prefers Option 1; as end users we do not see the need for additional requirements to be placed on depositaries in this regard. AIFMs which are hedge fund managers will typically be receiving such information about settlement from their brokers; there should not be any need for the depositary also to set up some procedure (with its attendant costs) which is of no discernible benefit to AIFMs.

Section 2 Due diligence duties (p.172)

MFA General Comment on Due Diligence Duties

When conducting due diligence on the appointment of a sub-custodian (in line with the criteria in paragraph 1(a) of Box 88 (p.172)) MFA considers that the depositary should be allowed to take into account whether an AIFM or AIF has specifically requested for that particular sub-custodian to be used in its assessment of whether that sub-custodian complies with the criteria. MFA believes that these requirements should be flexible for AIFMs who may have a preference as to the jurisdiction and/or identity of sub-custodians for their AIFs.

Paragraph 3 of Box 88 requires that the depositary "terminate the contract in the best interest of the AIF and its investors where the delegate no longer complies with the requirements" in that box. MFA is of the view that this is undesirable and could be harmful to investors in AIFs because termination at the instance of the depositary may result in uncertainty from the AIFM's perspective as to the status of its assets . To avoid this result, the AIFM should always be given the option in relation to such termination.. MFA recommends that this paragraph 3 of Box 88 be deleted.

Section 3 Segregation (p.175)

MFA General Comment on Segregation

MFA notes the reference in paragraph 2 of Box 89 to applicable law preventing the segregation objective from being met. MFA believes that this amounts to "an external event beyond the depositary's reasonable control" for the purposes of the depositary liability regime (see below).

Question 46: What alternative or additional measures to segregation could be put in place to en-sure the assets are 'insolvency-proof' when the effects of segregation requirements which would be imposed pursuant to this advice are not recognised in a specific market? What specific safeguards do depositaries currently put in place when holding assets in jurisdictions that do not recognise effects of segregation? In which countries would this be the case? Please specify the estimated percentage of assets in custody that could be concerned.

MFA supports ESMA's acknowledgement of the use of omnibus accounts by sub-custodians rather than requiring the depositary's safekeeping functions to be delegated only to third parties who segregate the assets of each AIF; the use of omnibus accounts reflects current market practice.

V.IV. The depositary's liability regime

MFA General Comment on the depositary's liability regime

MFA is keen to support a depositary's liability regime that will be workable in practice. In particular, MFA supports a regime whereby depositaries which delegate to sub-custodians are not simply held liable for all acts of the sub-custodian. For example, fraud at the level of a sub-custodian should be considered to be an external event beyond the depositary's control, rather

than an internal event as suggested by ESMA at paragraph 29 (p.184) of this section. MFA is concerned that if depositaries are held strictly liable for events like fraud at a sub-custodian, depositaries will be unlikely to wish to delegate to certain entities, even if they are needed by the AIFM to perform essential functions for its AIF (*e.g*. in certain emerging markets jurisdictions where local custodians may be required).

VI. POSSIBLE IMPLEMENTING MEASURES ON METHODS FOR CALCULATING THE LEVERAGE OF AN AIF AND THE METHODS FOR CALCULATING THE EXPOSURE OF AN AIF (p.191)

Question 55: 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?

Question 56: 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?

Question 57: Is further clarification needed in relation to the treatment of contingent liabilities or credit-based instruments?

Question 58: 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?

Question 59: Which of the three options in Box 99 do you prefer? Please provide reasons for your view.

Question 60: 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?

MFA General Response

MFA notes that ESMA has rejected the use of the Value at Risk ("VaR") methodology in its consultation paper (see paragraph 10, page 192) and preferred instead to use the Commitment Method (in addition to the Gross Method). Given the very wide range of types of AIFs and strategies that may be employed, MFA believes that in order to provide flexibility and to identify the most appropriate measure of exposure for an AIF, AIFMs should be permitted to utilise a variety of methods, including VaR. As the European Central Bank noted in its paper *Hedge Funds and their Implications for Financial Stability*:

> "Accounting-based balance sheet measures of leverage [such as gross/net balance sheet leverage] fail to reflect the risk of the assets. Risk-based measures [such as VaR] alleviate this shortcoming by relating market risk to the capacity to absorb it."[4]

In respect of the Commitment Method, MFA notes ESMA's proposal (at paragraph 35-37 of this section) to impose a very narrow definition of hedging arrangements, in line with the CESR Guidelines. MFA believes that the CESR Guidelines, which were drawn up for the UCITS framework, do not reflect an approach that should be used for AIFMs. Unlike UCITS, which may require a more conservative approach due to the fact that UCITS are retail products, investors in AIFs are professional/institutional and would expect "hedging" to include hedging

[4] *Hedge Funds and their Implications for Financial Stability*, ECB, 2005, at page 30.

strategies that are commonly used outside of the UCITS framework. One example ESMA gives of a situation which does not comply with its suggested hedging criteria is a where a person hedges a long equity position of an issuer with a CDS on bonds of the same issuer, on the basis that the hedging relates to two different asset classes. This sort of hedging is precisely the kind of hedging engaged in financial markets on a daily basis, and ought to be recognised for AIFs/AIFMs under the Commitment Method. Otherwise it is difficult to contemplate how the Commitment Method could reasonably be of use.

MFA also believes that the Advanced Method should not be seen to be a unique method by which specific notification and other requirements need to be imposed in order for it to be used. The Advanced Method should simply be one of the options available to AIFMs, so that AIFMs can choose the method most appropriate for their AIFs (Gross/Commitment, VaR, Advanced).

Specifically in relation to Question 56, MFA does not consider it desirable for further specifications to be included within the Advanced Method. The parameters as currently proposed by ESMA give sufficient freedom to AIFMs to use a methodology other than commitment method whilst ensuring that the calculation of exposure is not understated.

VII. POSSIBLE IMPLEMENTING MEASURES ON LIMITS TO LEVERAGE OR OTHER RESTRICTIONS ON THE MANAGEMENT OF AIF (p.209)

MFA General Comment

MFA fully supports strong, stable and predictable markets. In that regard, MFA believes that the sudden imposition of limits on the leverage that an AIFM may employ or other supervisory restrictions on the management of AIFs, without adequate warning and consultation, could result in significant market instability, and in some cases exacerbate or prolong the market turmoil that that competent authority is seeking to address.

MFA appreciates that in emergency situations, it is sometimes necessary for regulators to take immediate action without the benefit of public consultation. However, as the same time, markets depend on investor confidence and certainty. As investors, we respectfully suggest that actions taken precipitously and without the benefit of public consultation, undermine, rather than bolster, investor confidence. The lack of an opportunity for public consultation means that regulators are forced to make decisions with, at best, limited opportunity to obtain market intelligence.

Moreover, such precipitous actions make it difficult for investors and other market participants to manage their investment activities thoughtfully under predictable circumstances. When competent authorities issue regulations with far-reaching implications for market participants and those regulations take effect immediately, there is no opportunity for the competent authorities to issue interpretive guidance to assist market participants with compliance efforts.

Question 61: 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 that 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.

As a general principle, MFA believes that any decision to impose such limits or other restrictions on the management of AIFs should be taken only after prior consultation, considered analysis of empirical data, a thorough impact assessment and cost/benefit analysis and coordinated action between regulators.

Whilst MFA agrees with ESMA that it is not appropriate to set strict or pre-determined timeframes or rules regarding the timing of any imposition, MFA believes that any such action by a national regulator should be taken only in very limited circumstances.

Accordingly, MFA considers that, before any imposition of limits or restrictions on the use of leverage by a AIFM, there needs to be coordinated action between regulators and/or sufficient warning before any competent authority acts in setting any limits or restrictions. MFA notes that the national regulator's determination as to whether to impose leverage limits or other restrictions on an AIFM (or group of AIFMs) is subject to the notification procedures set out in Article 25(2) and Article 25(4) of AIFMD. However, MFA suggests considering a mechanism

by which ESMA coordinates with the national regulator as to whether to impose any limits or restriction (*i.e.* having ESMA: (i) consider the proposed action by the national regulator within a certain time; (ii) issue advice to the national regulator as to whether the action is appropriate; and (iii) give the AIFM (or group of AIFMs) sufficient notice of the proposed action so that the effect of the proposed action can be properly considered without causing instability or turmoil – in particular, for investors).

Question 62: 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?

As a general comment, Article 25(3) of the Directive provides that limits on leverage may only be imposed in order "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" (*i.e.* to reduce systemic risk). Therefore any "additional factors" to be considered by ESMA should be restricted to reduction in systemic risk; for example, investor protection should not in and of itself be a factor, particularly since AIF investors are professional investors.

VIII TRANSPARENCY REQUIREMENTS

VIII.I Possible Implementing Measures on Annual Reporting (p.216)

Question 63: 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?

MFA has no comment on this question.

Question 64: 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?

As a preliminary matter, MFA notes that the Directive clearly contemplates (see Recital 4) that, prior to the passport regime possibly becoming mandatory for all AIFMs, there is a transitional period during which national (*i.e.* private placement) regimes should continue to apply to non-EU AIFMs marketing AIFs in the EU. During this transitional period, non-EU AIFMs do not get the benefit of the EU passport and, accordingly, are not required to comply with the operative provisions of the Directive other than Articles 26 to 30 (disclosure and transparency). As and when the passport regime is either opted into by the non-EU AIFM in 2015 or possibly imposed by the Directive in 2018/2019, non-EU AIFMs will have to comply with all of the other Articles of the Directive.

Accordingly, while a non-EU AIFM markets AIFs in the EU under the national private placement regime (*i.e.* not under the passport), the requirements of Article 13/Annex II of the Directive to have remuneration policies do not apply to such non-EU AIFMs (and would not apply unless/until the non-EU AIFM utilised the passport regime). That being the case, the corresponding requirement under Article 22(2)(e) and (f) for an AIFM to report the amount of remuneration should not apply to such a non-EU AIFM prior to the application of the passport.

If, notwithstanding the above, such reporting of total remuneration is required, then MFA would note that paragraphs 5 and 6, Box 106 (p.226), along with ESMA's explanatory note in paragraph 27(iv) (p.227), which require that AIFMs provide general information relating to their remuneration *policies*, does not apply. That is, even if information about total remuneration paid is disclosed, non-EU AIFMs marketing under the national private placement regime are not subject to any requirement which relates to remuneration *policies*, because the requirement in Article 13/Annex II of the Directive to have remuneration policies do not apply to such non-EU AIFMs.

At the recent open hearing on 2 September 2011 at ESMA's offices, ESMA staff appeared to suggest that the requirement to have remuneration policies will apply to non-EU AIFMs from implementation of the Directive on the basis that, if not, there would not be a level playing field with EU AIFMs. However, MFA submits that that the reverse is true – requiring non-EU AIFMs to comply with the Article 13 remuneration policy requirements when such non-EU AIFMs do not have the benefit of the EEA passport, would create an unlevel playing field with EU AIFMs.

Requiring non-EU AIFMs to comply with the Article 13 remuneration policy requirements is also contrary to the Directive. Prior to the introduction of the passport regime for non-EU AIFMs, there is no requirement in the Directive for non-EU AIFMs to have remuneration policies; Article 13 of the Directive does not apply. It is only after the introduction of the passport regime for non-EU AIFMs that it becomes necessary, in order to establish a level playing field, to require non-EU AIFMs to introduce remuneration policies under Article 13 to bring them on a par with the obligations imposed on EU AIFMs.

The discussion above in relation to remuneration disclosure under Article 22(2) applies equally to other items of disclosure required under Articles 23 to 24 of the Directive. In particular, the following reporting items in Article 23 do not apply to a non-EU AIFM as the underlying requirements do not apply prior to application of the passport regime:

- Article 23(1)(d) – identification of the AIFM's depositary;
- Article 23(1)(e) – a description of how the AIFM is complying with the additional own funds/professional indemnity insurance requirement in Article 9(7);
- Article 23(1)(f) – a description of any delegated management function as referred to in Annex I by the AIFM and of any safe-keeping function delegated by the depositary, the identification of the delegate and any conflicts of interest that may arise from such delegations;
- Article 23(1)(g) – a description of the AIF's valuation procedure and of the pricing methodology for valuing assets, including the methods used in valuing hard-to-value assets in accordance with Article 19;
- Article 23(1)(m) – the latest net asset value of the AIF or the latest market price of the unit or share of the AIF, in accordance with Article 19;
- Article 23(2) – any arrangement made by the depositary to contractually discharge itself of liability in accordance with Article 21(13), and any changes with respect to depositary liability.

In relation to Article 24, the requirement under Article 24(2)(e) to report to competent authorities "the results of the stress tests performed in accordance with point (b) of Article 15(3) and the second subparagraph of Article 16(1)" does not apply because Articles 15 and 16 do not apply to a non-EU AIFM prior to application of the passport.

VIII.III Possible Measures on Reporting to Competent Authorities (p.235)

MFA General Comment on Confidentiality

MFA notes that in its proposals regarding regulatory reporting requirements, ESMA has not addressed or discussed the protection of confidentiality in respect of proprietary information that will be provided by AIFMs under the Directive.

MFA understands the importance of market participants providing information to competent authorities so they can determine whether there are potential risks in the financial system. However, because much of the information being provided to regulators will be sensitive and/or proprietary, it is critical that such information be kept confidential, both by regulators receiving the information, and any other regulatory body who may otherwise receive such information (such as ESMA and ESRB).

MFA asks ESMA to include in its recommendations to the Commission a provision to make clear that the regulatory reporting forms submitted under the Directive are confidential and will not be made public and that, should any competent authority need to disclose regulatory reporting information, that it does so in an aggregated and anonymous form so that it does not identify, either directly or indirectly, any AIF, or provide indications of specific activities in a particular market.

MFA considers that confidentiality is of great importance to AIFMs and the effective working of the alternative investment fund industry as a whole. Public disclosure, even if inadvertent or delayed, of highly sensitive, proprietary business information would result in immediate and irreversible damage to the competitive position of a fund and its investors.

MFA also notes that it has raised similar concerns with the SEC in respect of the Dodd-Frank Act implementation. In the U.S., information that fund managers submit on Form PF will be subject to important confidentiality protections under Section 404 of the Dodd-Frank Act. MFA strongly supports these protections and asks that ESMA look to adopt a similar approach. MFA encourages regulators to develop robust measures to ensure that confidential information is not disclosed.

Question 69: Do you agree with the proposed frequency of disclosure? If not, please provide alternative suggestions.

MFA considers that reporting on a quarterly basis is excessive. MFA is concerned that, if competent authorities receive such volumes of reports on a quarterly basis, competent authorities may not have the resources properly to analyse the information so as to be able to consider whether systemic risk issues are raised. In particular, in Member States with large fund management industries, the national competent authority may be overwhelmed with information. If the authorities are not able properly to analyse the information, the result may be that the financial system may carry on without potential systemic risk being identified.

MFA believes that semi-annual reporting would be more consistent with the purpose of the reporting requirement to enable competent authorities to identify whether any AIFs merit further analysis. Information about AIFs' investments, use of leverage and collateral, counterparty exposures, and portfolio management practices provided semi-annually would provide the competent authorities with meaningful data to monitor and assess the extent to which large AIFs could have systemic effects. As an alternative, ESMA could recommend starting this new reporting on a semi-annual basis, and then re-evaluate the process after a period of time (say, two years) to determine if more frequent reporting would add substantial value.

Question 70: What costs do you expect completion of the reporting template to incur, both initially and on an ongoing basis? Please provide a detailed analysis of cost and other implications for different sizes and types of fund.

MFA has no comment on this question.

Question 71: 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?

MFA believes the suggested one month period is too short. Regardless of the reporting frequency, MFA would urge ESMA to consider giving AIFMs more time in which to prepare the information. It is difficult to prepare the information (especially where it must be done every quarter) within one month of the end of the relevant period. MFA believes that 90 days is a more realistic requirement and hopes ESMA will recommend that period to the Commission. Stipulating a reporting period less than 90 days would severely limit the ability of AIFMs to properly value illiquid assets, diverge significantly with industry practice and could ultimately result in less meaningful information being provided to competent authorities.

Many of the illiquid assets held by certain AIFs, such as hedge funds, are categorized under generally accepted accounting principles ("GAAP") as having Level 2 or Level 3 inputs.[5] Level 2 inputs are observable, either directly or indirectly, but do not include quoted prices in active markets for the same assets.[6] AIFMs that hold assets with Level 2 inputs need to obtain pricing information directly from third party sources, including valuation agents, underwriters and other participants in the markets for those assets.

Level 3 inputs are unobservable, and are used when observable inputs are not available and there is little, if any, market activity for the asset. In valuing assets with these inputs, managers often develop their own models and assumptions to price the asset based on the best information available, and engage third party valuation firms to review their valuation methodology and provide any relevant data or assumptions about the valuation of the assets.

AIFMs seeking to obtain inputs for these assets depend on valuation agents, underwriters, brokers and other market participants to provide accurate, timely information. It is important that AIFMs have sufficient time to receive this information, to then use the information to prepare their portfolio valuations for investors, and finally to use this final information as a basis for the calculations used for reporting to the relevant competent authority. In this manner, AIFMs will be able to ensure that regulatory reporting information is consistent with information provided to investors. While the length of time each AIFM will need to complete this process will depend on an AIFM's valuation methodology, the type and proportion of illiquid assets, the AIF's investment strategy, and the availability of information from third party sources, it would be extremely difficult for AIFMs to be able to obtain the necessary information within one month.

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[5] See Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 157, Fair Value Measurements.

[6] A Level 2 input would include, for example, a quoted price for an identical or similar asset in a market that is not active (i.e., markets in which there are few transactions for the asset, prices are not current, or price quotations vary substantially either over time or among market makers, or in which little information is released publicly).

Additionally, AIFMs provide extensive reporting to AIF investors. Compressing the regulatory reporting process would require AIFMs to create multiple valuation procedures, independent of those that support investor reporting and would diminish the value and accuracy of information reported to a competent authority. Much of the information proposed to be reported to a competent authority is unique and will have to be generated solely for that purpose, so the burden on AIFMs will be substantial. Having to complete this task in only one month would be unreasonable and would increase the cost to AIFMs substantially.

Many AIFMs will seek to automate the reporting process as much as possible; however, as described above, the reporting obligations required under the Directive may nevertheless require substantial hours to complete, and the involvement of personnel across a number of departments, including risk management, legal, compliance, and trading and portfolio management. Requiring AIFMs to complete this process in one month would significantly increase the costs that AIFMs will incur, divert personnel from their primary job functions and increase the risk of inaccurate or erroneous information.

For these reasons, we ask that ESMA recommend that AIFMs be given 90 days from the end of the relevant period to submit the regulatory reporting information.

Question 72: 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?

MFA has no comment on this question.