

### **Summary (2% of original text):**

AIFMD regulates the management of alternative investment funds and the marketing of these funds to professional investors in the EU. 3 Member States may impose additional requirements for the marketing of AIF to retail investors.

In the following the terms 'level 2 measures' and 'implementing measures' are used interchangeably, for this IA report they comprise all 'delegated acts' and 'implementing acts' covered by the Commission's mandate to CESR/ESMA, but not regulatory or implementing technical standards and guidelines which ESMA will have to develop on its own initiative and which have not to be impact assessed by the European Commission.

In addition to these two risks there are several other forms of risks which are linked to the investments of a fund such as market risk, counterparty risk or liquidity risks which are the subject of the risk management of AIFM.

The chapter provides an overview of the overall problems to be addressed and objectives to be achieved in keeping with the level 1 Directive.

A high level definition of leverage as contained at level 1 does not ensure that leverage is calculated in a harmonised way by AIFM.

The impact of delegations between the depositary and its sub-custodian on the depositary's liability is further clarified by Article 21(12) which provides that "the depositary's liability shall not be affected by any delegation".

Most assets are currently valued 'mark to market'; which means that the AIF uses the current market value of the asset in its book records.

Once the values of all assets have been established, the AIFM will be able to calculate the total value of the assets under its management.

It can be concluded that the valuation of assets for the calculation of the total assets under management should be done in the same way.

The calculation includes the value of all assets under management (AuM) by the AIF without deducting the liabilities.

In contrast to option 3, FDIs are valued at their equivalent position in the underlying assets, not at their market value.

A uniform approach to the calculation of total AuM will ensure a consistent approach to whether AIFM are to be seen as above the threshold, and that those that should be subject to the regulations designed for those above the threshold are uniformly so subject.

The calculation methods of options 3 and 4 offer a more comprehensive view of the exposures of AIF/AIFM because liabilities are not deducted.

ESMA identifies potential increases in costs for small AIFs investing extensively in FDIs because they might be obliged to follow the AIFMD regime which would not have been the case under the other options.

Such costs can also be assessed against the benefits bestowed by the Directive, in particular the "EU passport".

While AuM adds up the value of all assets, exposure focuses on the value of fund assets which is exposed to, for example, market risk or credit risk.

Option 3 (Gross method): The exposure of an AIF calculated in accordance with the gross method is the sum of the absolute value of all positions, i.e. all assets purchased plus the absolute value of all liabilities, valued in accordance with Article 19 of the Directive.

Except for special assets still valued according to national accounting standards, most of the assets are valued across Europe in the same way ("mark-to-market").

As AIFMD sets minimum requirements for the marketing of AIF to retail investors as well, the leverage figure calculated with the gross approach would also have to be disclosed to them.

The reporting of the leverage calculated with these two methods would be appropriate to depict the leverage of AIFs.

Proper and harmonised calculation of leverage should benefit many stakeholders; in particular investors who would get useful and comparable information that should help them in their investment decisions.

Once the exposure is determined, the leverage is calculated by dividing the exposure by NAV.

To determine the appropriateness of these funds or PII, three main features have to be specified: firstly, what should be the basis for the calculation of additional own funds and secondly, how should this basis be calculated and finally, what would be the amount or percentage of this basis that has to be held as additional own funds.

Option 2 (Income): An income-based approach (the "Basic Indicator Approach") is being used in Directive 2006/48/EC relating to the taking up and pursuit of business of credit institutions, which considers operational risk to rise with the income (basically the capital cushion for operational risk is calculated on the basis of the net income).

own funds could be calculated in terms of both income

It would have the disadvantage that the relevant income would have to be defined and then calculated by all AIFM.

bankruptcy of the AIFM. Failures of AIFM which result in losses to investors could undermine investors' confidence in the sector and lead to significant reallocations of funds with uncontrollable impacts on markets.

Option 3.3 (Total assets using underlyings): The calculation of additional own funds would be done in the same way as in option 3.2 with the only difference, that derivatives have to be converted into an equivalent position in the underlying asset.

Like option 3.1, the calculation of total assets would not create significant costs in the calculation of additional own funds.

Contrary to the case of the calculation of total assets under management, the calculation of additional own funds does not focus on the potential risks of assets, but rather on the value of the assets themselves.

As option 3.1 would risk to underestimate additional own funds for AIFM of funds with high liabilities while option 3.3 would risk to overestimate operational risks in some cases this 'ranking' in

The final step in the analysis, the determination of the multiplication factor for additional own funds/PII, is presented in Annex 11 as no clearly defined options could be identified.

The principal aim of Article 21(8) is that custody extends to all financial instruments that can be registered in accounts on the depositary's books or that can physically be delivered to the depositary.

In relation to financial instruments that can be held in custody, Article 21(8)(a)(i) requires the depositary to hold in custody "all financial instruments that can be registered in a financial instruments account opened in the depositary's books" (Article 21(8)(a)(i) AIFMD).

The arrangement is commonly referred to as book entry transfer.

On the downside, option 3 would exclude from the scope of custody financial instruments that can be registered in the financial instruments account in the depositary books but that are not settled through a settlement system.

Option 3 would arguably limit the scope of financial instruments to be held in custody beyond what Article 21(8)(a)(i) AIFMD (see above) provides.

In consequence, the option would offer a lower level of investor protection than that required by the AIFMD.

It balances between ensuring a high level of investor protection while providing the needed flexibility to the depositary's industry and not putting the entire responsibility on the depositaries.

The depositary duty to ensure that AIF's cash flows are properly monitored serves the objective of investor protection.

The risk of fraud would also be significantly reduced but would not be totally avoided.

The size in terms of AuM could be measured by AIF and by AIFM, secondly, the AIFMD pays particular attention to the treatment of funds investing in non-listed companies and issuers in order to acquire control.

(a) AIFM managing portfolios of AIFs whose AuM below the thresholds calculated in Article 3(2)(a) and (b) shall report on an annual basis;

Option 3 (Asset type) distinguishes between liquid assets which tend to be traded more frequently and illiquid assets for which buying and selling usually takes some time and involves considerable transaction costs so that these assets are not traded frequently.

As the commitment method for the calculation of leverage provides a leverage figure that reflects the economic impact of an AIF, it seems appropriate to focus on AIF whose use of leverage needs to be monitored more in depth in order to assess whether this fund, individually or together with others, might pose a risk for the functioning of certain markets or even the financial system as a whole.

The review should be based on public consultation and discussions with competent authorities.

There is no need for a transposition/implementation plan.

Assets under management: value of assets that an investment company manages on behalf of investors.

Collateral arrangements may take different legal forms; collateral may be obtained using the method of title transfer or pledge.

Leverage can be generated by borrowed money that a fund employs to increase buying or selling power and increase its exposure to an investment or by using derivative instruments that embed already leverage.

Exposure of a fund or any investor describes the extent to which it is exposed to market risk, credit risk or other types of risk.

Calculation of thresholds not to allow AIFM to circumvent regulation, nor to empty the level 1 exemption

o Treatment of AIFM in one and the same calendar year occasionally exceed and/or fall below the relevant threshold: Assessment of IA need Calculations by [...] showed that there were only a very limited number of AIFM with total assets under management (AuM) close to the threshold in France.

The classification is not exhaustive and has not been fundamentally challenged in consultations run by ESMA, no relevant alternatives to this approach have been presented.

As the types of AIFM differ even more than the types of UCITS, such implementing measures have to take a relatively general, principles-based approach which makes it difficult to develop clearly defined distinct options and to impact assess differences between them.

The AIFM has also to ensure that the net asset value per share or unit of AIF is calculated and disclosed to the investors in accordance with this Article, the applicable national law and the AIF rules or instruments of incorporation.

This issue is not assessed in the main body of this impact assessment.

(i) The depositary shall hold in custody all financial instruments that can be registered in a financial instruments account opened in the depositary's books and all financial instruments that can be physically delivered to the depositary;

- Ensure that calculation of leverage does not allow AIFM circumventing regulation

- Ensure that calculation of leverage does not allow AIFM circumventing regulation - Ensure that supervisors are provided with relevant information in a format that allows it to be disseminated and aggregated in a timely manner - Reduce weakness in investor disclosures;
- Ensure proper management of conflicts of interest; - Ensure appropriate controls and processes in key risk areas - Ensure that information is comparable across Member States and similar AIFM/AIF

- The first problem is that the funds can find it costly and difficult to set themselves up and gather investments, particularly from investors in Member States other than one in which they are based.

A rough estimate based on these fund sizes and numbers of funds gives a market that could be of around EUR 500 million to around EUR 4000 million.

Any factor above 0,1 or 10% would seem disproportionately high as the "Basic Indicator Approach" used in Directive 2006/48/EC relating to the taking up and pursuit of business of credit institutions is at 15% but covers a much wider range of risks.

The leverage in the option calculated with the gross method equals the exposure divided by NAV in this simplistic example of only one asset which is a derivative:  $13.554,70/996,00 = 13,6$   
Table 13.2: Total asset calculation and leverage AuM of the option if valued at its market price: 996,00€ AuM of the option if valued at the value of the underlying: 13.554,70€ Leverage embedded in the option: 13,6

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.

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.

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.

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.

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.

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.

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.

The 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.

The provision allows the general framework set by ESMA to be adapted to the nature, scale and complexity of the AIFM.

193. Some asset managers were of the opinion that Box 38 reflected the general principles of risk management and should either be deleted or tied in with the relevant implementing provisions on risk management.

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.

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.

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.

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.

The requirement in option 1 to mirror transactions would be very expensive and duplicate the work of fund administrators.

Some respondents felt that both options inappropriately narrowed the scope of the depositary's duties as set out at Level 1.

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.

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.

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.

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.

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).

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.

111.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.

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.

492. According to several respondents there was no need for further clarification.

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.

130. 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.

While the 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 be complied with at all times.

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.

149. 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.

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