AFME Response to CESR Call for Evidence (CESR/10-1459) on Implementing Measures on the Alternative Investment Fund Managers Directive

To: ESMA

Date: 14-01-11

Introduction and Structure of Response

On behalf of the AFME[1] Prime Broker Committee, we hereby respond to your 03-12-10 Call for Evidence on Implementing Measures on the Alternative Investment Fund Managers Directive (AIFMD).

In our response, we firstly set our general comments on the Call for Evidence (CfE) and as appropriate respond to the specific questions posed by CESR in addition to those set out in the European Commission (EC) Request for Technical Advice. Against this background, we then respond to the specific questions in the Request for Technical Advice where we consider it appropriate to do so. In the latter context, our comments are accordingly focused on the delegation of AIFM functions and the depositary function.

Process

Whilst we welcome the decision to extend the response deadline by one week, we ask ESMA to note that the short response time (including the Holiday period) for the CfE has constrained our ability to provide detailed and comprehensive comment. On that basis, please treat this response as preliminary and non–exhaustive. We note that ESMA plans to conduct further public consultations in light of the responses received to the CfE and its own deliberations – we look forward to providing input on these consultations as ESMA develops its Technical Advice on AIFMD Level 2 measures, including supporting analysis of the costs of compliance.

Questions raised by CESR in Addition to those in EC Request for Technical Advice

Q2: Among the topics that will be covered by the implementing measures, which do you consider would be most appropriately adopted in the form of regulations or directives?

We believe that the appropriate form of instrument for the implementing measures is through directive. In particular, in relation to the depositary aspects of the implementing measures, material differences in national legal regimes pertaining to proprietary rights, insolvency law and the settlement and title transfer mechanics present significant challenges in adopting legislation which would be effectively applied in all regimes. We therefore feel that some degree of flexibility for national securities regulators to interpret and apply the legislation would be appropriate. If the AIFMD were implemented by regulation and not by directive, national regulators / legislators would be denied the possibility of 'interpreting' the standards set by the AIFMD and the Level 2 Measures according to local (common) law and/or market practice. For these reasons we believe directive(s) would be the most appropriate vehicle for Level 2 measures in the depositary function area.

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[1] AFME, the Association for Financial Markets in Europe, promotes fair, orderly, and efficient European wholesale capital markets and provides leadership in advancing the interests of all market participants.. AFME represents a broad array of European and global participants in the wholesale financial markets, and its 197 members comprise all pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME provides members with an effective and influential voice through which to communicate the industry standpoint on issues affecting the international, European, and UK capital markets. AFME is the European regional member of the Global Financial Markets Association (GFMA). For more information, visit the AFME website, www.AFME.eu.

Q3: Can you identify useful sources of data and statistical evidence from which CESR could benefit in the preparation of its advice?

We suggest that one of the main sources of data and statistical evidence may be the information gathered by the regulators themselves in the course of their monitoring and supervisory activities. We also note that the EC is about to commission work for its own impact assessment on some of the Level 2 measures. The sectors most closely affected and their associations (AIMA for the hedge fund managers, AGC for the custody industry and BVCA/EVCA for the venture capital/private equity industry) should also be prime candidates. In addition, various private sector estimating companies (e.g. BarclayHedge, CSFB/Tremont) have been cited in other reports in this area.

Issues/Questions in EC Request for Technical Advice

Issue 10 – Article 20 Delegation of AIFM functions

We welcome and support the statements by the Commission in 'III. Commentary' that the delegation provisions in the implementing legislation should target an appropriate level of consistency with the corresponding provisions in MiFID and UCITS. We are of the view that delegation of functions has in the past, and will continue, to provide flexibility for managers in the appointment of service providers with expertise in various areas, in turn providing benefit to investors, as well as affording suitable protections as set out below.

Noting that the AIFM cannot delegate portfolio management or risk management to the depositary or a delegate of the depositary, we make the following comments regarding a number of the other conditions of delegation:

1) Re. the need to justify the delegation structure with 'objective reasons', we consider the principal objective benefits of delegation to be :

    i) The investor obtains access to global investment capabilities

       For instance, a fundamental global investment mandate where the Contracted EU based asset manager delegates to entities located in various jurisdictions such as Asia and the US for investment decisions on local stocks. In the interests of their clients, global asset managers often base their decisions on the inputs of delegated entities close to the markets they invest in and ideally physically situated there. So for instance the decisions to purchase/sell Chinese stocks will be taken in Hong Kong.

    ii) The investor obtains access to global trading capabilities

       For instance, again, a fundamental global investment mandate where the Contracted EU based asset manager delegates to entities located in various jurisdictions such as Asia and the US for investment decisions on local stocks. In the interests of their clients, including the fair treatment of investors in the pooled funds that they operate, there are significant advantages to investors in an EU based asset manager being able to trade globally through delegates in the same time zone as the market being traded in.

    iii) The investor obtains access to global strategies managed from outside the EU

       For instance, certain strategies may be managed from one location to achieve economies of scale and the benefits of all team members being in the same location;

so for instance a quantitative investment team may be solely based in one location as unlike a fundamental investment team it does not need to be near the markets it covers as it only uses publicly available quantitative inputs to manage portfolios. And because the quant business and the supporting world of research and academia in this particular area is strongest in the US and because it is important to have the team members together in one location (as real time collaboration and improvement of the models is part of the competitive advantage that is being offered) that quant team may well be based in New York.

2) Re. the 'sufficiency of resources/good repute/experience' of the delegate, we note that the delegate will not necessarily be an authorised firm and that in such cases, the AIFM (who is authorised) will need to demonstrate to the competent authority that it has acted with due diligence in selecting and monitoring the delegate. Where the delegate is an authorised firm, we submit that the AIFM should be able to rely on the authorisation of the delegate and conduct such additional checks as are judged warranted in the circumstances and as are appropriate depending on the functions delegated.

3) Re. ensuring co-operation between supervisory authorities in cases where the delegate is a third country entity, we suggest that an IOSCO MoU should be sufficient. EU Competent Authorities may wish to consider a standard form annex to their IOSCO MoUs reflecting their additional responsibilities and powers.

4) Referring to Question 4, we believe that: a) A written/durable medium should required to for an AIFM to demonstrate that it has consented to a sub-delegation. This consent should be permitted to be broad enough to encompass any appropriate sub-delegation; so that, e.g. , there would not be a requirement for a prime broker to whom custody may be delegated to seek fresh approval for every change in sub-delegation to sub-custodians within its sub-custody network; b) The criteria to be taken into account when determining and addressing (via segregation) material conflicts of interest should be based on current rules (such as those of the FSA) and practice in money management and the HFSB recommendations. Disclosure of these risks should rest as the responsibility of the AIFM; and c) The form and content of notification to the authorities should be based on a standard written form across Member States.

5) Re. Conditions under which AIFM would be considered to have become a 'letter box' entity. We note that, given the Directive expressly provides that some functions cannot be delegated and that liability rests with the AIFM who will also as a result of the Directive be subject to enhanced regulatory supervision and scrutiny, it is difficult to conclude that any AIFM will become a complete 'pass through' entity. We suggest that annual audits of AIFM which indicate that the AIFM has reviewed/monitored its delegation arrangements should be sufficient to satisfy the authorities that the entity has not become a 'letter box'.

Part II: Depositary (Article 21)

By way of background to our responses to the issues raised under Part II, we reiterate our firm view that the options for structuring prime services arrangements envisaged by the AIFMD should be preserved at Level 2. We consider that the AIFMD foresees three options for the provision of prime brokerage services: 1) The prime broker provides both counterparty and custodial services. It has the functional and hierarchical separation required by Article 21(4) and is appointed as depositary of the AIF; 2) The prime broker provides both counterparty and custodial services, but it is not the depositary and is therefore appointed as sub-custodian by the

depositary in relation to its custodial activities only; or 3) The prime broker acts as counterparty and will hold assets of the AIF as security for the AIF's obligations to it and to enable it to perform certain of its functions as prime broker including clearing and settlement services. In this case the depositary's responsibilities will be to verify that the AIF has ownership of the assets held by the prime broker pursuant to Article 21.7(b) but those assets, while they remain in the control of the prime broker will not be held in custody by the depositary under Article 21.7(a).

Issue 11 - Contract evidencing appointment of the depositary

We question the need for a 'model' agreement. Depositaries will necessarily review and amend their own forms of agreement to comply with the new requirements imposed by the AIFMD, but they should also have the flexibility to take their own business models into account when doing so. We would therefore suggest that Level 2 legislation is not necessary to impose further requirements on depositary agreements, although Level 3 guidance may be helpful in providing legal certainty including on the appropriate interpretation of certain legislative terms such as the meaning of 'permanent lost'.

Issue 12 - General criteria for assessing equivalence of the effective prudential regulation and supervision of third countries

Given that depositaries are mostly authorised as credit institutions, we note that in cases where the banking and securities supervisor are separate, the ESMA member (securities supervisor) may not be able to conclude the same sort of MoU with the banking supervisor as securities supervisors have among themselves. Also, assessing 'effective enforcement' in third countries where enforcement is conducted in private may be difficult. In this context, ESMA may be able to take comfort from the IMF Financial Sector Assessment Program (FSAP) work. See http://www.imf.org/external/NP/fsap/fsap.asp

Issue 13.1 – Depositary functions pursuant to paragraph 6 **[AIF Cash Flows]**

Referring to Question 1, third bullet regarding the condition that 'none of the depositary's own cash is kept in the same accounts', we comment that this requirement does not appropriately reflect debtor/creditor nature of bank accounts or scenarios where the CSD cash account is a single account in the name of the sub-custodian. In the latter cases, that cash account will contain: the global custodian's cash, the global custodian's client's cash, and the global custodian's client's client's cash.

We recommend that ESMA consider the framework in place through audit processes to monitor cash flows, payments and cash holdings and seek to permit reliance on external audit review or third party administrators who manage those fund flows where administrators are so appointed.

In relation to the equivalence standards referred to in Question 2, again we would encourage the use of the IOSCO framework for determining the standard of regulation applied in non EU jurisdictions. We believe it will be important for the Commission to remain open to other jurisdictions and not to establish criteria which are practically or technically very difficult to meet, which could in turn discourage funds from conducting business in the EU.

We would also recommend that a procedure be established for publication of a list of jurisdictions which meet the relevant criteria – in order for AIFM to have certainty it will be necessary for the Commission to indicate whether a jurisdiction's regime meets the relevant criteria – this information should be made broadly available so that it can be applied consistently.

We would welcome the Commission's clarification that the provisions of Paragraph 6 are intended to permit the holding of cash by prime brokers. Paragraph 6 could be construed as only permitting banks to hold cash of AIF, whereas in practice, cash is held with prime brokers (investment firms) – clarification that the language 'an entity of the same nature' would include, for example, an FSA-regulated investment firm would be welcome.

Issue 13.2 - Depositary functions pursuant to paragraph 7 **[Safekeeping]**

In terms of responsibilities and ensuing liability under the AIFMD, we emphasise the need for a clear separation and delineation of a given prime broker's possible roles, specifically between cases where assets have been transferred as collateral to the prime broker in its capacity as financing counterparty, and cases where the prime broker is acting as sub-custodian providing basic custody, clearing and settlement services.

Although not included in the EC's list of provisions requiring further attention, we also believe that clarification is required around the expression 'functionally and hierarchically separated' in the context of depositary functions (Article 21).

In relation to Question 2, the difference in national legal regimes in questions of ownership and property rights and title again affirm the importance of directive rather than regulation as the format for the implementing measures. Different jurisdictions have different procedures, evidentiary standards and requirements and levels of rights and interests to various forms of property which are not consistent across the Community. We therefore consider it important to retain national implementing regulation which can accommodate these differences effectively. This is particularly true of the 'other assets' referred to in Paragraph 7(b). (Where the depositary is responsible for the verification of ownership of 'other assets' according to paragraph 7(b), it will also be important also to clarify that a depositary can place reliance on independent verification of ownership.)

Issue 13.3 - Depositary functions pursuant to paragraph 8 **[Custody]**

Where a depositary is required to ensure that the functions referred to in paragraph 8 are conducted in accordance with applicable national law or the constitutional documents of the AIF, we believe it should be adequate for the depositary to rely on the services offered in this regard by an appropriately qualified and properly delegated administrator in the relevant jurisdiction or on the review by external auditors of these functions.

Issue 14: Due diligence

The CfE asks for guidance on what should constitute 'all due skill, care and diligence' in the appointment of a sub-custodian and what constitutes 'periodic review and ongoing monitoring'. A good starting point should be to highlight practices within banks and the network management currently undertaken to implement the legal requirements of FSA (e.g. in relation to the CASS requirement, systems and controls, operational risk monitoring etc). This may be

instructive on the nature and level of due diligence required or intended under the AIFMD and help ESMA shape its comprehensive template of evaluation.

Issue 15 - The segregation obligation

The differences in national regimes relating to holding structures and requirements for various assets, including client asset protection regimes, again highlight the importance of maintaining the ability at a national level to implement the proposals in a way which accommodates those regimes. We therefore reiterate our view that the appropriate format for the implementing legislation is through directive(s).

We think it is important to stress that the implementing measures should take full account of the fact that the local laws/market practices of certain jurisdictions in which a sub-custodian operates may require that *all* assets deposited with such sub-custodian be held in a single account. Technical advice issued by ESMA at Level 2 should acknowledge that full segregation throughout the sub-custody chain would be impossible to achieve in practice, and indeed may not be possible as a matter of local law in many jurisdictions.

Although not included in the EC's list of provisions requiring further attention, we also believe that clarification is required around the use of the term 'ensure' as this is used throughout the AIFMD and in particular in relation to the steps which the depositary (or a prime broker to whom the depositary has delegated duties) is required to take - see in particular paragraph 10(d) of Article 21 requiring the depositary to ensure that third parties to whom functions have been delegated fulfil a list of conditions on an ongoing basis.

We believe that the wording in the Directive needs to be clarified as to whether it means 'must' (as an ordinary reading of the word might suggest) or a standard such as: 'must take those commercially reasonable steps that a responsible custodian would take to ensure'. The current lack of clarity leads to material uncertainty as to potential depositary liability.

For example, an EU depositary acting for a hedge fund is asked to agree to the appointment of a sub-custodian. The depositary carries out normal due diligence to 'ensure' that rehypothecation has been authorised. The sub-custodian then defaults. Is the depositary liable for a failure to segregate assets that were:

1. Inadvertently over-rehypothecated by the sub-custodian? or
2. Not initially over-rehypothecated, but which due to movements in market value became excess to the agreed limits of rehypothecation? or
3. Assets which the sub-custodian had been obliged to buy on behalf of the fund but which had settled inadvertently in the sub-custodian's house account?; or
4. Rehypothecated, but that the fund had later specifically demanded the return of but had not settled in the contractually agreed time?; or
5. Not segregated due to an elaborate fraud at the sub-custodian that could not have been uncovered by the due diligence that could reasonably be expected of a depositary.

Until market participants have clarity on the liability arising on these types of scenarios, a depositary will find it difficult to assess the level of risk that it is undertaking when agreeing to the appointment of a sub-custodian.

Issue 16 - Loss of financial instruments

We agree that the questions set out in Issue 16 regarding the conditions and circumstances in which a financial instrument should be considered 'permanently lost' cf. temporarily 'unavailable' should be addressed as a matter of priority. Technical advice should be issued to provide legal certainty that circumstances as to when financial instruments are 'permanently lost' will not include situations where a loss is caused by a delay or unavailability (e.g. by a sub-

custodian's insolvency). We believe differences in Member State legal regimes in relation to the 'availability' of assets and the application of insolvency regimes will make it difficult to apply the liability standards in a universal way, which adds further weight to case for using directive(s) rather than regulation(s) to ensure effective implementation.

In addition, we note the differing documentation/liability issues arising from a bank's network management conducting both AIFM and non-AIFM business. Currently, network management divisions negotiate documentation (including commercially agreed liability standards) covering the agent networks for all lines of a bank's business. Under the AIFMD, the agent network could be classed as sub-custodians resulting in potentially different liability documentation standards being prescribed by EU legislation for one isolated line of business compared with all other lines of business.

Issue 17 - External events beyond reasonable control

We believe it will not be possible to provide an exhaustive list of the events which would be beyond the reasonable control of the relevant depositary. Furthermore, what is within the 'reasonable control' of a depositary will be dependent on the relevant regime applicable in any given jurisdiction where the assets are held or relevant parties are situated, and therefore it will be important to apply these criteria at a national level. For example, while strikes and riots are considered as 'force majeure' under English law, French law does not regard events that can be foreseen as force majeure and so exclude strikes and riots from 'force majeure'. We believe that a depositary, who has appropriately delegated functions in accordance with the provisions of the Directive, has contracted for the discharge of liability to the delegate for those delegated functions, and has not itself acted negligently in the course of that delegation, should properly be regarded as not having 'reasonable control' over the delegate where the delegate has wilfully or negligently acted in a way which has caused loss to the AIF or the AIFM, or has acted beyond the scope of its delegated powers or breached its obligations under that delegation. In particular, there is need for clarity on whether the insolvency of a sub-custodian would be viewed as an "external event beyond reasonable control".

Issue 18 - Objective reason to contract a discharge

In relation to Question 1, we believe there are a number of scenarios in which the depositary should properly be regarded as having an objective reason for the discharge of its liability to a delegate performing custody functions. For example, where a depositary is acting for an AIF or AIFM in relation to numerous different asset classes or jurisdictions, it will be necessary for the proper performance of the depositary functions to delegate custody functions to custodians who are appropriately authorised and who have the relevant expertise to conduct that business in each relevant jurisdiction or market. Depositaries may also seek to use more than one custodian in any given market or to appoint a delegate even where the depositary itself is able to perform the functions in the particular market, based on criteria such as the intention to minimise key service provider risk or to maximise efficiency by the use of more than one custodian in a market. Where those functions are effectively delegated, it is appropriate to delegate the liability for those delegated custody functions as the delegate in those circumstances is objectively the entity which is in control of the relevant assets. This would, in our view, be an appropriate objective criterion for discharging the liability to the local custodian to whom those functions are delegated in the relevant market.

We stand ready to provide further detail on any of the above comments if ESMA would find this helpful. In any event, we look forward to continuing to work with ESMA towards clear and appropriately framed AIFMD Level 2 measures

Yours sincerely

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