Alternative Investment Management Association

AIMA NOTE

Analysis of divergences between t**he EU Commission's draft** regulation implementing the AIFMD and the ESMA advice

April 2012

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Introduction

The recently released EU Commission draft regulation implementing the Directive 2011/61/EU on Alternative Investment Fund Managers (AIFMD) diverges significantly from the technical advice provided to the Commission by ESMA. This note sets out to document and analyse important policy departures from the ESMA advice observed in the EU Commission's draft, highlighting some of the unintended consequences of the proposed changes.

It appears that the changes highlighted in this document cannot be the result of "translation" of technical recommendations into legal language with the aim of providing greater clarity or legal certainty. This is because the changes often introduce new policies which have not been recommended by ESMA, leave out ESMA advice completely or reconfigure the parameters which ESMA put forward following technical discussions with experts.

The types of changes to the ESMA advice can be broadly classified into seven categories:

- Additions of new legal obligations to those proposed by the ESMA advice
- Deletions without replacement of entire policy areas of ESMA advice
- Subtle drafting modifications which result in potentially large policy changes
- Change or replacement of technical parameters proposed by ESMA advice
- Restrictions on the provision of certain services only to EU entities
- Deletions of proportionality or materiality provisions
- Replacement of clear provisions with ambiguous language

In terms of content, the areas where changes have been made include the following

- Definition of assets under management
- Own funds
- Leverage
- Professional indemnity insurance
- Organisational requirements
- Delegation
- Risk management
- Transparency
- Depositaries
- Third countries

The rest of the note is organised as follows. Annex 1 provides detailed examples of the types of policy changes that have been introduced in the Commission's draft regulation text. Annex 2 highlights some of the key content changes. Annex 3 provides a more comprehensive textual comparison and a side-by-side analysis of the ESMA advice and the draft regulation text.

Conclusion

The differences between the Commission draft regulation and the ESMA advice seem to be both significant and wide-ranging. If implemented without modification, the proposed Commission text could be disruptive to the asset management industry in the EU and globally, potentially undermining some of the stated policy goals of investor protection and financial stability.

Annex 1

Types of changes introduced in the draft regulation

- Additions of new legal obligations to those proposed by the ESMA advice

Example: the AIFMD does not allow the AIFM to outsource its tasks to the extent it becomes a letter box entity and can therefore no longer be considered to be managing the fund portfolio. In its technical advice on the AIFMD implementing measures, ESMA was asked to clarify what this requirement, which has been carried over from the UCITS and MiFID directives, means.

ESMA stated that if the manager no longer retains the necessary expertise and resources to supervise the delegated tasks effectively and manage the risks associated with the delegation and if the manager no longer has the legal powers to take decisions in key areas of its responsibility, it will no longer meet the requirements of the AIFMD.

The Commission draft adds two additional conditions, one of which states that the totality of the individually delegated tasks cannot exceed the tasks remaining with the AIFM. This restriction on delegation is much more onerous than the existing practice in the majority of EU fund jurisdictions and goes beyond both the MiFID and the UCITS obligations. If implemented, the vast majority of EU-based funds and managers would have to significantly restructure their business without any apparent benefits to investor protection.

- Deletions without replacement of entire policy areas of the ESMA advice

Example: ESMA was asked to clarify which assets are capable of being held in custody by the depositary. In its advice, ESMA stated that assets which are subject to security and title-transfer collateral arrangements cannot be considered to be in custody by the depositary as the depositary no longer has any control over these assets.

Counterparty trading arrangements – which are negotiated, documented and entirely controlled by the AIFM on behalf of the AIF – place financial instruments legitimately beyond the control of the depositary. Such instruments cannot be held in custody because the counterparties hold them as collateral, which requires them to "possess" or "control" the collateral in order to perfect the security interest.

Under the proposed Commission's draft text, depositaries may be required to treat third parties, such as brokers appointed by AIFMs, collateral agents and central counterparties ("CCPs"), as delegates of the custody function whenever these third parties hold most financial instruments of the alternative investment fund ("AIF") as collateral for either party to a particular transaction.

This could potentially cause major disruptions in global capital markets. Furthermore, this would impose stress on banks which perform depositary functions, since they would become liable for losses caused by the failure of agents, brokers and CCPs, exacerbating the 'too-big-to-fail' problem.

Requiring depositaries to retain "control" of AIF financial instruments through delegation arrangements would fundamentally undermine the purposes served by the Financial Collateral Directive in providing a level playing field across title transfer and security financial collateral arrangements, which in turn would reduce certainty in the financial markets and therefore increase systemic risk in insolvency settings.

Other examples include the leaving out of the advanced method for the calculation of leverage, or leaving out the possibility to combine professional indemnity insurance and own funds to meet the requirements of the AIFMD.

- Subtle drafting modifications which result in potentially large policy changes

Example: Third country cooperation arrangements are the foundation of the third country regimes under the AIFMD. In general, the language and drafting of the third country provisions is inflexible in the Commission draft. It appears as though the text is creating obligations for EU competent authorities to enter into agreements with third country competent authorities which will have to achieve a number of outcomes, irrespective of context or other relevant conditions.

The ESMA advice states that the cooperation agreements which enable the functioning of the AIFMD third country regime should *provide for* a number of different areas, such as the exchange of information or assistance in enforcement between the relevant competent authorities. The Commission's text, on the other hand, creates an obligation on EU competent authorities *to ensure* via the cooperation agreements the access to all information necessary, the ability to carry out on-site inspections as well as the assistance of non EU competent authorities.

The Level 1 texts states that the cooperation agreements should be in line with international standards. One such widely used standard in the area of asset management is the IOSCO's Multilateral Memorandum of Understanding (MMoU) which operates on the basis of provision of fullest possible mutual assistance between competent authorities.

The IOSCO MMoU does not confer any enforceable legal rights upon its signatories and recognises that there are circumstances where requests for information exchange or other assistance may be legitimately denied, for example, in instances where such requests would be contrary to the relevant country's law or on the grounds of public interest.

The draft regulation seems to introduce strong and unqualified obligations for EU authorities to obtain all information and assistance necessary for the performance of their tasks under the AIFMD. Without clarification that such agreements are to be concluded on a best-efforts basis and cannot legally bind the EU and third country competent authorities, the third country regime could become unworkable.

- Change or replacement of key technical parameters proposed by ESMA

Example: ESMA was asked to provide the parameters of the insurance regime applicable to AIFMs who wish to cover the risks to investors arising from their professional activity via professional indemnity insurance. ESMA suggested that the coverage of the insurance per claim must be adequate for the individual AIFM's liability risk. The minimum coverage of the insurance for each claim must at least equal the higher of (a) 0.75 % of the amount by which the value of the portfolios of the AIFM exceeds €250 million (up to a maximum of €20 million) or (b) €2 million.

The Commission has provided that the coverage of the insurance for an individual claim must be at least equal to 0.7 % of the value of the portfolios of AIFs managed by the AIFM, without providing for either the €20 million cap or the €2 million alternative. The draft regulation therefore replaces technical parameters suggested by ESMA. The potential impact of this change is that professional indemnity insurance could become unavailable to fund managers.

- Restrictions on the provision of services to EU entities

Example: ESMA stated that when selecting counterparties or appointing prime brokers, AIFMs should ensure that counterparties and prime brokers are chosen which are subject to ongoing supervision by a public authority, are of financial soundness and have the necessary organisational structure for the services provided by them to the AIFM or the AIF.

The draft regulation goes much further and states that in appraising the financial soundness of the counterparties or prime brokers the AIFM must take into account whether they are able to comply

and continue to comply with the prudential requirements in accordance with Union law.

This would appear to restrict prime brokers and OTC counterparties to EU entities which clearly goes beyond the ESMA advice and does not seem justified in terms of the Level 1 text. This appears highly restrictive given typical prime brokerage models and the desire to source best terms in relation to credit and counterparty risk profiles across global OTC counterparties generally. It is difficult to see any basis on which it can be said that there is justification for determining financial soundness by reference to Union law only. Indeed, forcing EU AIFs to transact solely with EU prime brokers and banks could be to the detriment of investors in a number of areas.

Other examples include the restriction of the provision of professional indemnity insurers only to EU insurance companies.

- Deletions of proportionality or materiality provisions

Example: Taking into account the diversity of the AIFM industry, ESMA has proposed a number of proportionality provisions which would ensure that in applying the provisions of the legislation, due regard is taken to the nature, scale and complexity of the respective businesses. In many areas, these provisions have been taken up but there are areas where, inexplicably, the proportionality provisions have not been retained.

For example, ESMA states that the functional and hierarchical separation of portfolio or risk management tasks from any other potentially conflicting tasks within the delegate/sub-delegate should be calibrated to the nature, scale and complexity of the delegate/sub-delegate's business and to the nature and range of activities undertaken in the course of that business, on the understanding that the delegate/sub-delegate should, in any event, put in place specific safeguards against conflicts of interest allow for the independent performance of risk management activities. The draft regulation does not include this important calibration. Other examples include deletions of materiality provisions in financial statement provisions or rules on depositaries.

Since most asset managers are small businesses, deleting a number of the key proportionality provisions could mean those small businesses would no longer be able to operate under the AIFMD.

- Replacement of clear provisions with ambiguous language

Example: ESMA recommended that the additional own funds requirement should be recalculated at the end of each financial year.

The Commission has added that where the value of portfolios of AIFs managed increases significantly throughout the year, the AIFM must proceed without undue delay to the recalculation of the additional own funds requirement and adjust the additional own funds accordingly. However, the draft regulation does not indicate what a significant increase in the AUM could be.

Another example concerns the fair treatment of investors. While ESMA advice states that fair treatment by an AIFM includes that no investor may obtain preferential treatment that has an overall material disadvantage to other investors, the draft Commission regulation also creates an obligation for the AIFM to ensure that the principle of fair treatment of investors remains a crucial part of their business philosophy. It is not clear what the requirement would mean in practice and how the compliance with such a requirement could be demonstrated or enforced.

Annex 2

Summary of areas where divergence from ESMA advice is potentially seriously disruptive

- *Calculation of assets under management (methodology)* - The draft regulation does not consider the ESMA advice to exclude FX or interest rate hedging positions from the calculation of AUM.

- *Professional indemnity insurance (PII)/Own funds* - The ESMA text provides that the AIFM may take out professional indemnity insurance as an alternative to the requirements regarding additional own funds. The draft regulation leaves out the possibility to combine PII and own funds as per ESMA advice.

- *PII (no cap on cover)* – The levels of coverage in the draft regulation differ (are higher) from the ESMA text and there is no longer a cap on the level of PII cover.

- *PII (restrictions on insurance providers)* - The ESMA text allowed the AIFM to use third country insurance undertakings if the AIFM could demonstrate the viability of the third country insurance entity. It appears the draft regulation prohibits a non-EU insurer to provide PII.

- *Leverage (methods of calculation)* – Leaving out the advanced approach proposed by ESMA could create serious problems for the industry, its investors and competent authorities. Use of the UCITS commitment approach does not reflect the role of leverage in AIFs and could provide misleading picture of leverage in the industry.

- *Leverage (use of leverage on a substantial basis)* – The ESMA text states that it is impossible to use a single figure to designate the use of leverage on a substantial basis. The draft regulation instead proposes that an AIF will be considered to use leverage on a substantial basis if the leverage ratio exceeds 2 x NAV as calculated under the Commitment method.

- *Restriction on ability to use non-EU OTC derivative counterparties and non-EU prime brokers* - This is extremely problematic, and appears to go beyond the Level 1 text, would cause significant disruptions and be detrimental to AIF investors.

- *Delegation (definition of letter box entity)* – The wording on 'letter box entity' adds two new legal requirements which appear to restrict Level 1 flexibility significantly. These requirements are much stricter than the current UCITS standard operating in the majority of the EU fund centres.

- *Delegation (delegation to third country entities)* - Delegation to third country entities seems to be restricted by unworkable cooperation arrangements.

- *Depositaries (collateral)* – Assets subject to collateral arrangements were advised to be excluded from the scope of custody. The Commission has not taken up this policy advice. This could lead to a clash with the Financial Collateral Directive as well as EMIR

- *Depositaries (liability discharge)* - According to the ESMA advice the depositary should monitor external events which it "could reasonably identify". The concept of the event being reasonably identifiable has not been included in the draft regulation.

- *Third country cooperation arrangements* - The language and drafting of the third country provisions makes it sound as though the text is creating obligations for competent authorities to enter into binding agreements with third country competent authorities.

Annex 3

Detailed analysis of divergences from ESMA advice

Draft Regulation	ESMA Advice	Comments
Chapter II General provisions		
Article 3 *Calculation of the total value of assets under management* 3. For the purpose of calculating the total value of assets under management, each derivative instrument position, including any derivative embedded in transferable securities shall be converted into its equivalent position in the underlying assets of that derivative using the conversion methodologies set out in Article 12. The absolute value of this equivalent position shall then be used for the calculation of the total value of assets under management.	*Box 1* *Calculation of the total value of assets under management* 2. For the purpose of calculating the value of assets under management, each financial derivative instrument position, including derivatives embedded in transferable securities, should be converted into its equivalent position in the underlying assets of that derivative using the conversion methodologies set out in Box 99. The absolute value of this equivalent position should then be used for the calculation of the total assets under management. <u>However, foreign exchange and interest rate hedging positions that according to the investment strategy of the AIF are not used to generate a return should not be taken into account for the calculation of the total value of assets under management.</u>	The draft regulation does not exclude hedging positions from the calculation of AUM. This could result in AIFMs intended to fall out of the scope of the regulation as being below the thresholds would in fact be covered by the regulation.
Article 5 *Occasional breach of the threshold* 2. Where the total value of assets under management exceeds the relevant threshold and the AIFM considers that the situation is not of a temporary nature, the AIFM shall notify the competent authority without delay and seek authorisation <u>within 30 calendar days</u> in accordance with article 7 of Directive 2011/61/EU.	*Box 1* *Calculation of the total value of assets under management* 6. (a) Where the total value of assets under management exceeds the threshold the AIFM should notify the competent authority without delay stating whether the situation is considered to be of a temporary nature. In the affirmative, this notification should, where relevant, include supporting information to justify the AIFMs view regarding the temporary nature of the situation.	A new 30 day limit has been introduced for application for authorisation in the draft regulation when AIFM breaches the AUM threshold. This appears to be a fairly burdensome requirement as it could be extremely difficult for an AIFM, especially a small AIFMD, to get its full application ready for a submission within one month.
Articles 8-10 *Leverage*	*<u>ESMA Box 97</u>* *<u>Advanced Method of Calculating the Exposure of an AIF</u>* <u>1. An AIFM, having notified the competent authorities of its home Member State in accordance with Box 93, must calculate the exposure of an AIF it manages in accordance with the Advanced Method for all of the</u>	The draft regulation leaves out completely the advanced approach suggested in the ESMA advice.

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	assets of the AIF on the basis of the requirements below: (a) take into account paragraphs 4 and 5 of Box 94; (b) calculate exposure for each financial derivative instrument position with reference to the Commitment Method in accordance with Box 95 where that calculation provides a meaningful result; (c) in all other cases, the AIFM should employ a calculation method that it considers will result in an appropriate approximation of the AIF's exposure, which may include the estimated maximum loss; (d) offsetting arrangements may be taken into account in relation to all assets if they offset risks linked to all or part of an asset or liability of the AIF and the following conditions are satisfied: (i) the AIFM can demonstrate that the arrangements are likely to remain materially effective in times of stressed market conditions; and (ii) there is a verifiable reduction in risk at the level of the AIF; 2. For the purpose of calculating the exposure according to the Advanced Method, 'offsetting arrangements' means combinations of trades on financial derivative instruments and/or security positions which do not necessarily refer to the same underlying asset and where those trades on financial derivative instruments and/or security positions are concluded with the aim of offsetting risks linked to positions taken through the other financial derivative instruments and/or security positions. Offsetting arrangements may include combinations of trades which aim to generate a return. 3. In calculating the exposure of an AIF under the Advanced Method the AIFM should always take into account the following principles: (a) the methodology should be fair, conservative and not underestimate nor give a misleading view to investors of the exposure of the AIF; (b) the approach must be consistently applied over time and where applicable, between AIFs; and	

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	(c) the AIFM should demonstrate that the calculation method employed in accordance with paragraph 1(b) and the positions that are offset in accordance with paragraph 1(c) are consistent with how the AIFM manages risk within that AIF.	
Article 14 *Professional liability risks* 3. Professional liability risks include, without being limited to: (a) negligent loss of documents evidencing title of assets of the AIF; (b) misrepresentations or misleading statements made to the AIF or its investors; (c) negligent acts, errors or omissions resulting in a breach of: - legal and regulatory obligations; - duty of skill and care towards the AIF and its investors; - fiduciary duties; - obligations of confidentiality; - AIF rules or instruments of incorporation; - terms of appointment of the AIFM by the AIF; (d) failure to establish, implement and maintain appropriate procedures to prevent dishonest, fraudulent or malicious acts; (e) improper valuation of assets and calculation of unit/share prices; (f) business disruption, system failures, failure of transaction processing or process management.	*Definitions* 'Relevant person' means any of the following: (a) a director, partner or equivalent, or manager of the AIFM; (b) an employee of the AIFM, as well as any other natural person whose services are placed at the disposal and under the control of the AIFM and who is involved in the services of collective portfolio management by the AIFM; (c) a natural or legal person who is directly involved in the provision of services to the AIFM under a delegation arrangement to third parties for the purpose of the provision of collective portfolio management by the AIFM. *Box 5* *Potential risks arising from professional negligence to be covered by additional own funds or professional indemnity insurance* 1. The AIFM must be able to cover the potential liabilities arising from professional negligence. 2. The potential liability risks to be covered are the risk of losses arising from the activities of the AIFM for which the AIFM has legal responsibility. Those are particularly (a) Risks in relation to investors, products & business practices: Losses arising from a negligent failure to meet a professional obligation to specific investors and clients Those risks particularly include i. negligent loss of documents evidencing title of assets of the AIF ii. misrepresentations and misleading statements made to the AIF or its investors by the AIFM or the AIFM's directors, officers or staff or third parties for whom the AIFM has vicarious liability	3.(b) no longer contains the requirement from the ESMA advice that the misrepresentations and misleading statements made to the AIF or its investors be made "by the AIFM or the AIFM's directors, officers or staff or third parties for whom the AIFM has vicarious liability." 3. (c) is slightly broader that the ESMA advice – negligent acts, errors or emissions resulting in breach of fiduciary duties and duty of skill and care towards the AIF's investors are also included in the draft regulation. 3. (d) no longer contains the requirement from the ESMA advice that the dishonest, fraudulent or malicious acts be those of "the AIFM's directors, officers or staff or third parties for whom the AIFM has vicarious liability". 3. (d) also no longer specifies that the senior management put the above mentioned procedures in place. 3. (f) is missing the "negligent failure" wording from Box 5. (2)(b) of the ESMA guidance. Would mean AIFMs on hook for a force majeure event.

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	iii. negligent acts, errors or omissions by the AIFM resulting in a breach of: a. obligations according to law and regulatory framework b. duty of skill and care to the AIF when carrying out its professional activities c. obligations of confidentiality d. AIF rules or instruments of incorporation e. terms of its appointment by the AIF (except for internally-managed AIFs) iv. failure by the senior management to establish, implement and maintain appropriate procedures to prevent dishonest, fraudulent or malicious acts by the AIFM's directors, officers or staff or third parties for whom the AIFM has vicarious liability v. improper valuation of assets and calculation of unit/share prices (b) Risks in relation to business disruption, system failures, process management: Losses arising from negligent failure resulting in the disruption of business or system failures, from failed transaction processing or process management	
Article 15 *Qualitative requirements addressing professional liability risks* 1. The AIFM shall implement effective internal operational risk management policies and procedures in order to identify, measure, manage and monitor appropriately operational risks including professional liability risks to which the AIFM is or could be reasonably exposed. The operational risk management activities shall be performed independently. 2. The AIFM shall set up a historical loss database, in which any operational failures, loss and damage experience shall be recorded. This database shall record without being limited to any occurred professional liability risk events as described under article 1 paragraph 3. 3. Within the risk management framework the AIFM shall make use of its historical internal loss data and where	*Box 6* *Qualitative Requirements (based on Annex X Directive Part 3 2006/48/EC)* The AIFM should implement effective internal operational risk management policies and procedures in order to identify, measure, manage and monitor appropriately operational risk including liability risks to which the AIFM is or could be reasonably exposed. The operational risk management activities shall be performed independently. For this purpose the AIFM should, appropriate to the size and organisation of the AIFM and the nature, scale and complexity of its business, establish and maintain a separate operational risk management function in accordance with the requirements set out in Box 30.	In article 15(1) the "appropriate to the size and organisation of the AIFM and the nature, scale and complexity of its business" wording has not been carried across from ESMA Box 6(1).

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appropriate of external data, scenario analysis and factors reflecting the business environment and internal control systems. 4. Operational risk exposures and loss experience shall be monitored on an on-going basis and shall be subject to regular internal reporting.		
Article 16 *Additional own funds* 3. The additional own funds requirement shall be recalculated at the end of each financial year and the amount of additional own funds shall be adjusted accordingly. An AIFM shall establish, implement and apply procedures to monitor on an ongoing basis the value of portfolios of AIFs managed. Where before the annual recalculation referred to in the previous subparagraph the value of portfolios of AIFs managed increases significantly, the AIFM shall proceed without undue delay to the recalculation of the additional own funds requirement and adjust the additional own funds accordingly.	*Box 7* *Quantitative Requirements* 1. The additional own funds requirement for liability risk is equal to 0.01% of the value of the portfolios of AIF managed by the AIFM. 2. The own funds requirement is recalculated and, if necessary, adjusted at the end of each financial year. 3. The competent authority of the home Member State of the AIFM may authorize the AIFM to lower the percentage to 0.008%, provided that the AIFM can demonstrate – based on its historical loss data according to Box 6 and a minimum historical observation period of three years – that liability risk according to Box 5 is adequately captured. Conversely, the competent authority may raise the additional own funds requirements if they are not sufficient to capture liability risk arising from professional negligence.	Article 16(3) is a new requirement to recalculate and adjust Additional Own Funds where there has been significant change in AUM prior to end of financial year.
Article 17 *Professional indemnity insurance* 1. This article applies to AIFMs that choose to cover professional liability risk through professional indemnity insurance. 2. An AIFM shall take out and maintain at all times professional indemnity insurance that is complying with the following requirements: (a) the insurance policy shall have an initial term of no less than one year; (b) the insurance policy shall have a notice period for cancellation of at least 90 days; (c) the insurance policy shall cover professional liability risks as defined in Article 1 paragraphs (1) to (3) of this Regulation;	*Box 8* *Professional Indemnity Insurance* 1. As an alternative to the requirements in Box 7 paragraph 1 regarding additional own funds, the AIFM may take out and maintain at all times professional indemnity insurance complying with the following requirements: (a) The insurance policy must have an initial term of no less than one year; (b) The cover provided by the policy is wide enough to include the liabilities of the AIFM's directors, officers or staff or third parties for whom the AIFM has vicarious liability; (c) The liability risks listed in Box 5 are covered; (d) Any defined excess is covered by own funds which	The wording in Article 17(2)(e) requiring that "the insurance is taken out from an insurance undertaking authorised to transact professional indemnity insurance, which is subject to prudential regulation and on-going supervision in accordance with Union law". It is unclear whether this prohibits a non-EU insurer or whether an equivalence test is envisaged. The ESMA advice provided for the case of third country insurance undertakings and allowed the AIFM to use third country insurance undertakings if the AIFM could demonstrate the viability of the third country insurance entity. 2 (b) The Regulation requires that the insurance policy shall have a notice period for cancellation of at least 90 days – this was not in the ESMA advice.

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(d) any defined excess shall be fully covered by own funds which are in addition to the own funds to be provided according to Article 9(1) and 9(3) of Directive 2011/61/EU; (e) the insurance is taken out from an insurance undertaking authorised to transact professional indemnity insurance, which is subject to prudential regulation and on-going supervision in accordance with Union law; (f) the insurance is provided by a third party entity. 3. The coverage of the insurance for an individual claim must be at least equal to 0.7 % of the value of the portfolios of AIFs managed by the AIFM calculated as set out in article 3(2). 4. The coverage of the insurance for claims in aggregate per year must be at least equal to 0.9 % of the value of the portfolios of AIFs managed by the AIFM calculated as set out in article 3(2). 5. The AIFM shall review the professional indemnity insurance policy and its compliance with the requirements set in this article at least once a year and in the event of any change which affects compliance of the policy with the requirements.	are in addition to the own funds to be provided, where applicable, according to Article 9(3) and 9(7)(a) of Directive 2011/61/EU; (e) The insurance is taken out from an insurance undertaking authorised to transact professional indemnity insurance, which is subject to prudential regulation and ongoing supervision. In case of third country insurance undertakings, the AIFM has to demonstrate to the competent authority, that those requirements are fulfilled and that the insurance undertaking has sufficient financial strength with regard to the claims paying ability; (f) The insurance is provided by a third party entity; 2. The coverage of the insurance per claim must be adequate for the individual AIFM's liability risk. The minimum coverage of the insurance for each claim must at least equal the higher of the following amounts: (a) 0.75 % of the amount by which the value of the portfolios of the AIFM exceeds €250 million, up to a maximum of €20 million; (b) €2 million. 3. The coverage of the insurance for claims in aggregate per year must be adequate for the individual AIFM's liability risk. The minimum coverage of the insurance for all claims in aggregate per year must at least equal the higher of the following amounts: (a) 1 % of the amount by which the value of the portfolios of the AIFM exceeds €250 million up to a maximum of €25 million; (b) €2.5 million; (c) the amount calculated according to Box 7. 4. The AIFM should review the policy and its compliance with the requirements at least once a year and in the event of any change which affects compliance of the policy with the requirements.	3. and 4. The levels of coverage differ (are higher) from the ESMA advice and do not include caps.
	Box 9 *Rules for the combination of additional own funds and Professional Indemnity Insurance* 1. As an alternative to the requirements in Box 7 paragraph 1 regarding additional own funds and in Box 8	The Regulation does not allow for a combination of insurance and own funds, as ESMA suggested.

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

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	additional own funds and professional indemnity insurance calculated according to paragraph 2.	
Chapter III Operating conditions for AIFMs		
Article 20 *Due diligence* 1. AIFMs shall perform a high level of diligence in the selection and ongoing monitoring of investments, <u>including ownership verification of acquired financial instruments in order to prevent a situation referred to in Article 103(1)(a).</u> 2. AIFMs shall ensure that they have adequate knowledge and understanding of the assets in which the AIF is invested. 3. AIFMs shall establish, implement and apply written policies and procedures on due diligence and implement effective arrangements for ensuring that investment decisions on behalf of the AIFs are carried out in compliance with the objectives, the investment strategy and, where applicable, the risk limits of the AIF. 4. The policies and procedures on due diligence referred to in paragraph 2 shall be regularly reviewed and updated.	*Box 11* *Due Diligence requirements* 1. AIFMs should ensure a high level of diligence in the selection and ongoing monitoring of investments, in the best interests of the AIF, its investors and the integrity of the market. 2. AIFMs should ensure that they have adequate knowledge and understanding of the assets in which the AIF is invested. 3. AIFMs should establish written policies and procedures on due diligence and implement effective arrangements for ensuring that investment decisions on behalf of the AIF are carried out in compliance with the objectives, investment strategy and, where applicable, risk limits of the AIF. The due diligence processes and procedures should be regularly reviewed and updated.	The Regulation introduces a duty on the AIFM to verify ownership of acquired financial instruments. ESMA, as well as the Level 1 Directive suggest that this is to done by the depositary.
Article 22 *Acting honestly, fairly and with due skills* In order to establish whether an AIFM conducts its activities honestly, fairly and with due skills, the competent authorities shall assess, at least, whether the following conditions are met: (a) the governing body of the AIFM possesses adequate collective knowledge, skills and experience to be able to understand the AIFM's activities, in particular the main risks involved in those activities and the assets in which the AIF is invested; (b) members of the governing body shall commit sufficient time to properly perform their functions in the AIFM; (c) each member of the governing body shall act with honesty, integrity and independence of mind to		The requirements in relation to the governing body of the AIFM appears to be new.

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effectively assess and challenge the decisions of the senior management; (d) the AIFM shall devote adequate resources to the induction and training of members of the governing body.		
Article 23 *Fair treatment of investors in the AIF* 3. AIFMs shall ensure that the principle of fair treatment of investors remains a crucial part of their business philosophy. 4. The preferential treatment accorded by an AIFM to one or several investors cannot result in an overall material disadvantage to other investors.	*Box 19* *Fair treatment by an AIFM* Fair treatment by an AIFM includes that no investor may obtain a preferential treatment that has an overall material disadvantage to other investors.	Subsection 3's requirement of 'crucial part of their business philosophy' is new.
Article 26 *Reporting obligations in respect of execution of subscription and redemption orders* 1. Where AIFMs have carried out a subscription or, where relevant, a redemption order from an investor, they shall promptly provide the investor, by means of a durable medium, with the essential information concerning the execution of that order or the acceptance of the subscription offer as the case may be. 2. Paragraph 1 shall not apply where another person is obliged to provide the investor with a confirmation concerning the execution of the order and where the confirmation contains the essential information. AIFMs shall ensure that this other person complies with its obligations. 3. 'The essential information referred to in paragraph 1 and 2 shall include, at least, the following information: (a) the identification of the AIFM; (b) the identification of the investor; (c) the date and time of receipt of the order; (d) the date of execution; (e) the identification of the AIF; (f) the gross value of the order including charges for subscription or the net amount after charges for redemptions.	*Box 12* *Reporting obligations in respect of execution of subscription and redemption orders* 1. Where AIFMs have carried out a subscription or, where relevant, redemption order from an investor, they must promptly provide the investor, in a durable medium, with the essential information concerning the execution of that order and/or the acceptance of the subscription offer as the case may be. 2. Paragraph 1 shall not apply where another person is obliged to provide the investor with a confirmation concerning the execution of the order and where the confirmation contains the essential information. The AIFM has, however, to ensure that this other person complies with its obligations. 3. AIFMs shall supply the investor, upon request, with information about the status of the order and/or the acceptance of the subscription offer as the case may be.	Subsection 3 provides details of the essential information that must be supplied in relation to execution of subscription and redemption orders which was not in the ESMA advice.

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4. AIFMs shall supply the investor, upon request, with information about the status of the order or the acceptance of the subscription offer, or both as the case may be.		
Article 27 *Selection and appointment of counterparties and prime brokers* 1. When selecting and appointing counterparties and prime brokers AIFMs shall exercise due skill, care and diligence before entering into an agreement and on an ongoing basis by considering the full range and quality of their services. 2. AIFMs shall select counterparties and prime brokers which fulfill the following requirements: (a) are subject to ongoing supervision by a public authority; (b) are financially sound; and (c) have the necessary organisational structure for performing the services which are to be provided by them to the AIFM or the AIF. The list of selected prime brokers shall be approved by the AIFM's senior management. 3. In appraising the financial soundness of the counterparties or prime brokers referred to in paragraph 2(b) the AIFM shall take into account, in particular, whether they are able to comply and continue to comply with the prudential requirements in accordance with the Union law and the type of business pursued or which they envisage to pursue. 4. AIFMs shall appoint prime brokers from the list referred to in the second subparagraph of paragraph 2. In exceptional cases prime brokers not included in the list can be appointed provided that they fulfill the requirements laid down in paragraph 2 and subject to approval by senior management. The AIFM shall be able to demonstrate the reasons for such a choice and due diligence that it exercised in selecting and monitoring these prime brokers.	*Box 13* *Selection and appointment of counterparties and prime brokers* 1. When selecting and appointing counterparties and prime brokers AIFMs should exercise due skill, care and diligence before entering into an agreement and on an ongoing basis by considering the full range and quality of their services. AIFMs should ensure that counterparties and prime brokers are chosen which are subject to ongoing supervision by a public authority, are of financial soundness and have the necessary organisational structure for the services provided by them to the AIFM or the AIF. 2. For the purpose of paragraph 1 AIFMs should maintain a list of the appointed prime brokers approved by senior management. Only in exceptional cases and subject to approval by senior management may the AIFM appoint prime brokers not included in the list. The AIFM should be able to demonstrate the reasons for such a choice and the diligence that it exercised in selecting and monitoring these prime brokers. 3. For the purpose of this Box, counterparty means a counterparty of an AIFM or an AIF in an OTC transaction, in a securities lending or in a repurchase agreement.	Article 27(3) is new and would restrict prime brokers and OTC counterparties to EU entities.

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5. For the purpose of this Article, counterparty means a counterparty of an AIFM or an AIF in an OTC transaction, in a securities lending or in a repurchase agreement.		
Article 33 *Conflicts of interests* The AIFM shall identify, manage and monitor conflicts of interests arising between investors wishing to redeem their investments and those investors wishing to maintain their investments in the portfolio, and any conflicts between the AIFM's incentive to invest in illiquid assets and the AIF's redemption policy in accordance with their obligations under Article 14(1) of Directive 2011/61/EU.		This provision appears to be new.
Article 34 *Procedures and measures preventing or managing conflicts of interest* 1. The procedures and measures established for the prevention or management of conflicts of interest shall ensure that the relevant persons engaged in different business activities involving a conflict of interest carry out these activities having a level of independence which is appropriate to the size and activities of the AIFM and of the group to which they belong, and to the materiality of the risk of damage to the interests of the AIF or its investors.	*Box 22* *Independence in conflicts management* The procedures and measures provided for the management of conflicts of interest should be designed to ensure that relevant persons engaged in different business activities involving a conflict of interest carry on these activities at a level of independence appropriate to the size and activities of the AIFM and of the group to which it belongs, and to the materiality of the risk of damage to the interests of the AIF or its investors.	Article 34(1) now provides that procedures and measures established for the prevention or management of conflicts of interest "shall ensure", whereas ESMA's advice provides in paragraph 1 of Box 22 that such procedures "should be designed to" ensure.
Article 39 *Risk management systems* For the purposes of this Chapter risk management systems shall be understood as systems comprised of relevant elements of the organisational structure of the AIFM, with a central role for a permanent risk management function, policies and procedures related to the management of risk relevant to each AIF investment strategy as well as arrangements, processes and techniques related to risk measurement and management employed by an AIFM in relation to each AIF it manages.		A corresponding text was not included in the ESMA advice.

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Article 44 *Safeguards* 1. The governing body of the AIFM and, where it exists, its supervisory function shall employ safeguards against conflicts of interest that may pose the risk to the independent performance of risk management activities. These safeguards shall be documented in the risk management policy of AIFMs. 2. The safeguards referred to in paragraph 1 shall ensure that: (b) the remuneration of those engaged in the performance of the risk management function reflects the achievement of the objectives linked to the risk management function, independently from the performance of the business areas in which they are engaged. Where the risk management function is not functionally separated, this refers to the part of the remuneration which is linked to the risk management function; (c) where remuneration of those engaged in the performance of the risk management function is performance related, it shall be constructed in such a way as to reward the achievement of the objectives linked to the risk management function, sound risk-taking, in line with the business strategy of the AIFM and the risk profile of the AIF it manages;	*Box 30* *Functional and Hierarchical Separation of the Risk Management Function* 3. The governing body of the AIFM and, where it exists, the supervisory function, shall review the risk management function in accordance with paragraph 1. Where compliance cannot be achieved the governing body of the AIFM and, where it exists, the supervisory function, shall identify conflicts of interest that may pose a risk to the independent performance of risk management activities and shall ensure that procedures are in place which may reasonably be expected to result in an independent performance of the risk management function. These safeguards shall be documented in the risk management policy and must include from the list below (a), (b), (c) and (e) and may also include (d) and (f) where this is proportionate taking into account the nature, scale and complexity of the AIFM: (b) that staff members engaged in risk management are compensated in accordance with the achievement of the objectives linked to the risk management function, independent of the performance of the business areas in which they are engaged;	The draft regulation is more detailed that the ESMA advice as regards remuneration to staff members engaged in risk management as it includes specific rule on how to treat remuneration when the risk management function is not functionally separated.

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Article 81 2. The following entities are deemed as being authorised or registered for the purpose of asset management and subject to supervision according to Article 20(1) (c) of Directive 2011/61/EU : (a) management companies authorised under the Directive 2009/65/EC; (b) investment firms authorized under Directive 2004/39/EC to perform portfolio management; (c) credit institutions authorised under Directive 2006/48/EC having the authorisation to perform portfolio management under Directive 2004/39/EC; and (d) externally-appointed AIFMs authorised under Directive 2011/61/EU. 3. Where the delegation is conferred on a third-country undertaking in addition to the requirements stated above the following conditions have to be fulfilled in accordance with Article20(1) (d) of Directive 2011/61/EU:	*Box 68* *Delegation of portfolio management or risk management conferred on a third-country undertaking* 5. Where the delegation concerns portfolio management or risk management, the third country undertaking should be deemed to satisfy the requirement under Article 20(1)(c) when it is authorised or registered for the purpose of asset management based on local criteria and is effectively supervised by an independent competent authority.	*Delegation of portfolio or risk management* 81(3) requires that "Where delegation is conferred on a third country undertaking, in addition to the requirements stated above, the following condition have to be fulfilled". It is not clear which "requirements stated above" are intended to be referenced here and this should be made clear. It would not, for example, make any sense if the reference were to the requirements set out in paragraph 81(2) (namely that the 3rd country delegate has to also be one of the entities regulated by EU directives mentioned in that paragraph). We assume, instead, that this is simply a reference to the requirements specified in Article 20(1)(c) of the Level 1 Directive for a delegated portfolio or risk manager to be "authorised or registered for the purpose of asset management and subject to supervision". Note that paragraph 5 of Box 68 in ESMA's advice has not been reflected in the draft Regulation. It is not therefore clear in what circumstances a delegated third country portfolio or risk manager meets the requirements set out in Article 20(1)(c). The final bullet point under Article 81(3)(b) has its origins in the ESMA advice (paragraph 4(e) of Box 68) but additionally refers to breaches of "relevant national law". This is too wide: a reference to the Directive and its implementing measures suffices.
Article 82 *Effective Supervision* A delegation prevents the effectiveness of supervision of the AIFM if the following conditions are not satisfied: (c) the AIFM makes available on request to the competent authority all information necessary to enable the authority to supervise the compliance of the performance of the delegated functions with the requirements of the Directive 2011/61/EU, its implementing measures and relevant national law or.	*Box 69* A delegation would prevent the effective supervision of the AIFM, or the AIFM from acting, or the AIF from being managed, in the best interest of its investors in particular under the following circumstances: 1. A delegation would prevent the effective supervision of the AIFM where the AIFM does not take the necessary steps to ensure that the following conditions are satisfied (c) the AIFM makes available on request to the competent authority all information necessary to	*Effective Supervision* The requirement to make available on request to the competent authority all information necessary to enable the authority to supervise the compliance of the performance of the delegated functions should only apply to Article 20 of the Directive and not the whole Directive. This approach goes beyond the ESMA advice.

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	enable the authority to supervise the compliance of the performance of the delegated functions with the requirements of Article 20 of the AIFMD.	
Article 83 *Conflicts of interests* 1. Criteria to assess whether a delegation conflicts with the interests of the AIFM or the investor of the AIF shall include but shall not be limited to the following according to Article 20(2) (b) of Directive 2011/61/EU: (a) Where the AIFM and the delegate are members of the same group or have any other contractual relationship, the extent to which the delegate controls the AIFM or has the ability to influence its actions; (b) Where the delegate and an investor of the relevant AIF are members of the same group or have any other contractual relationship, the extent to which this investor controls the delegate or has the ability to influence its actions (c) the likelihood that the delegate makes a financial gain, or avoids a financial loss, at the expense of the AIFM or the investors of the AIF; (d) the likelihood that the delegate has an interest in the outcome of a service or an activity provided to the AIFM or the AIF; (e) the likelihood that the delegate has a financial or other incentive to favour the interest of another client over the interests of the AIFM or the investors of the AIF; (f) the likelihood that the delegate receives or will receive from a person other than the AIFM an inducement in relation to the collective portfolio management activities provided to the AIFM and its AIFs in the form of monies, goods or services other than the standard commission or fee for that service.	*Box 72* *Criteria to be taken into account when considering whether a delegation/ sub-delegation would result in a material conflict of interest with the AIFM or the investors of the AIF; and for ensuring that portfolio or risk management tasks haven been functionally and hierarchically separated from any other potentially conflicting tasks within the delegate/ sub-delegate; and that potential conflicts of interest are properly identified, managed, monitored an disclosed to the investors of the AIF* 1. Criteria whether a delegation/ sub-delegation would result in a material conflict of interest with the AIFM or the investors of the AIF: (a) Where the AIFM and the sub-delegate are members of the same group or have any other contractual relationship, it should be taken into account the extent to which the sub-delegate controls the AIFM or has the ability to influence its actions; (b) Where the AIFM is aware that the sub-delegate and an investor of the relevant AIF are members of the same group or have any other contractual relationship, it should be considered the extent to which this investor controls the sub-delegate or has the ability to influence its actions.	The criteria in 83(1)(c)-(f) were not in the ESMA advice.
2. The portfolio or risk management function can be considered as functionally and hierarchically separated from other potentially conflicting tasks only where the following conditions are satisfied: (a) those engaged in portfolio management tasks are not engaged in the performance of potentially conflicting tasks such as controlling tasks;	2.The portfolio or risk management tasks should be considered as functionally and hierarchical separated from other potentially conflicting tasks where the following conditions are satisfied: (a) Those engaged in portfolio management tasks are not engaged in the performance of potentially conflicting tasks such as controlling tasks;	In article 83(2)(d) the proportionality wording from ESMA Box 72 has been removed. We would suggest re-introducing the ESMA text.

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(b) those engaged in risk management tasks are not engaged in the performance of potentially conflicting tasks such as operating tasks; (c) those engaged in risk management functions are not supervised by those responsible for the performance of operating tasks; (d) the separation is ensured throughout the whole hierarchical structure of the delegate up to its governing body. It shall be reviewed by the governing body, and where it exists, the supervisory function of the delegate.	(b) Those engaged in risk management tasks are not engaged in the performance of potentially conflicting tasks such as operating tasks; (c) Those engaged in risk management tasks are not supervised by those responsible for the performance of the operating tasks; (d) The separation is ensured up to the governing body of the delegate/subdelegate. The functional and hierarchical separation of portfolio or risk management tasks from any other potentially conflicting tasks within the delegate/ sub-delegate should be calibrated to the nature, scale and complexity of the delegate/ sub-delegate's business and to the nature and range of activities undertaken in the course of that business, on the understanding that the delegate/ sub-delegate shall, in any event, put in place specific safeguards against conflicts of interest allow for the independent performance of risk management activities.	
3. The following requirements have to be fulfilled in order for potential conflicts of interest to be properly identified, managed, monitored and disclosed to the investors of the AIF: (a) The AIFM shall ensure that the delegate takes all reasonable steps to identify, manage and monitor potential conflicts of interest that may arise between itself and the AIFM or the investors of the AIF. Therefore, the AIFM has to ensure that the delegate has procedures in place corresponding to those required under Articles 32 to 35. (b) The AIFM shall ensure that the delegate discloses potential conflicts of interest as well as the procedures and measures to be adopted by it in order to manage such conflicts of interest to the AIFM which shall disclose them to the investors of the AIF in accordance with Article 36.	*Box 72* *Criteria to be taken into account when considering whether a delegation/ sub-delegation would result in a material conflict of interest with the AIFM or the investors of the AIF; and for ensuring that portfolio or risk management tasks haven been functionally and hierarchically separated from any other potentially conflicting tasks within the delegate/ sub-delegate; and that potential conflicts of interest are properly identified, managed, monitored an disclosed to the investors of the AIF* 3. Criteria whether potential conflicts are properly identified, managed, monitored and disclosed to the investors of the AIF: The delegate/ sub-delegate should take all reasonable steps to identify, manage and monitor conflicts of interest that may arise between the delegate/ sub-delegate and the AIFM or the investors of the AIF. The delegate/ sub-delegate should disclose potential conflicts of interest as well as the procedures and measures to be adopted by it in order to manage such	In article 83(3)(a) the AIFM is now required to ensure that a delegate has procedures in place to correspond to those under Articles 32 to 35. The detail in this article appears to go beyond what was envisaged by Level 1 and ESMA in Box 72(3).

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	conflicts to the AIFM which should disclose them to the investors of the relevant AIF.	
Article 85 *Letter-box entity and AIMF no longer managing an AIF* 1. The AIFM shall be deemed a letter-box entity and shall no longer be considered to be the manager of the AIF at least in any of the following situations: (a) the AIFM no longer retains the necessary expertise and resources to supervise the delegated tasks effectively and manage the risks associated with the delegation; or (b) the AIFM no longer has the power to take decisions in key areas which fall under the responsibility of the senior management or no longer has the power to perform senior management functions in particular in relation to the implementation of the general investment policy and investment strategies; (c) the AIFM loses its contractual rights to inquire, inspect, have access or give instructions to its delegates or the exercise of such rights becomes practically impossible. (d) the totality of the individually delegated tasks substantially exceeds the tasks remaining with the AIFM.	*Box 74* *Letter-box entity* The AIFM would become a letter-box entity and could no longer be considered to be the manager of the AIF where: 1. the AIFM no longer retains the necessary expertise and resources to supervise the delegated tasks effectively and manage the risks associated with the delegation; or 2. the AIFM no longer has the power to take decisions in key areas which fall under the responsibility of the senior management or no longer has the power to perform senior management functions in particular in relation to implementation of the general investment policy and investment strategies.	The draft regulation introduces a quantitative test for "letter-box entities" as paragraphs (c) and (d) were not included in the ESMA advice. The letter box entity wording in Article 85 is far wider than equivalent provisions in Articles 13 and 14 of UCITS. Article 85(1)(a)-(c) are the converse of Articles 22, 60, 78. It is unclear what the negative wording in Article 85 adds to the positive obligations in these Articles. The quantitative measure, imposed by article 85(1)(d), will not be possible to assess and conflicts with Article 22, 60 and 78. Many UCITS management companies/delegations would fail on this measure. It confuses day-to-day "tasks" with ultimate legal authority and responsibility which would still reside with the AIFM. The consequences of 85(1)(d) would be that it would: (a) undermine existing legitimate fund structures and the general ability to delegate (as reaffirmed under Level 1 and ESMA advice) - the end result would be to restrict EU professional investor access to cross-EU border and global investment strategies; (b) fundamentally reduce/remove the benefit of seeking dual authorised UCITS/AIFM management companies as the AIFM could not delegate to the same entities as under a UCITS delegation (e.g. the common delegation of day to day portfolio and risk management by a UCITS management company to a MiFID manager on an individual portfolio management basis would not be permitted under 85(1)(d); (c) make most internally-managed models unviable without substantial restructuring and insourcing e.g. the investment trust board would be unable to delegate day to day portfolio/risk management to a third party manager without substantial insourcing/restructuring. Article 85(1)(d) fundamentally misinterprets and

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		narrows the flexibility deliberately given in Level 1 - the test is significantly more onerous than that for self-managed UCITS.
Chapter IV Depositary		
Article 86 *Contractual particulars* 1. The contract by which the depositary is appointed according to Article 21(2) of Directive 2011/65/EU shall be drawn up between the depositary on the one hand and the AIFM or/and the AIF or another entity acting on behalf of the AIF on the other hand and shall at least include the following elements: (a) a description of the services to be provided by the depositary and the procedures to be adopted for each type of asset in which the AIF may invest and which shall then be entrusted to the depositary; (b) a description of the way in which the safe-keeping and oversight function shall be performed depending of the type f asset and the geographical regions in which the AIF plans to invest. With respect to the custody duties this description shall include country lists and procedures to add and/or withdraw countries from that list. This shall be consistent with the information provided in the AIF rules, instruments of incorporation and offering documents regarding the assets in which the AIF may invest; (c) a statement that the depositary's liability shall not be affected by any delegation of its custody functions unless it has discharged itself of its liability in accordance with the requirements of Article 21(13) or (14) of Directive 2011/61/EU; (d) the period of validity and the conditions for amendment and termination of the contract including the situations which could lead to the termination of the contract as well as details regarding the termination procedure and, if applicable, the procedures by which the depositary should send all relevant information to its successor; (e) the confidentiality obligations applicable to the	*Box 75* *Particulars to be included in the written agreement evidencing the appointment of a single depositary and regulating the flow of information deemed necessary to allow the depositary to perform its functions pursuant to Article 21 (2) of the AIFMD.* The depositary on the one hand and the AIFM and / or the AIF on the other hand shall draw up a written agreement setting out the rights and obligations of the parties to the contract. This agreement should include at least the following elements: 1. A description of the services to be provided by the depositary and the procedures to be adopted for each type of asset in which the AIF may invest and which may be entrusted to the depositary; 2. A description of the types of asset that will fall within the scope of the depositary's safekeeping and oversight function which should be consistent with the information provided in the AIF rules, instruments of incorporation and offering documents, regarding the assets in which the AIF may invest; 3. A statement that the depositary's liability shall not be affected by any delegation of its custody functions unless it has discharged itself of its liability in accordance with the requirements of Article 21 (13) or (14); and where applicable, the conditions under which the AIF or the AIFM may allow the depositary to transfer its liability to a sub-custodian including the objective reasons that could support that transfer; 4. The period of validity, and the conditions for amendment and termination of the contract; and, if applicable, the procedures by which the depositary should send all relevant information to its successor; 5. The confidentiality obligations applicable to the	The requirements introduced on the contract are more detailed in the Regulation than in ESMA advice.

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parties in accordance with prevailing laws and regulations; these obligations shall not impair the ability of Member States competent authorities to have access to the relevant documents and information; (f) the means and procedures by which the depositary will transmit to the AIFM or the AIF all relevant information that it needs to perform its duties including the exercise of any rights attached to assets, and in order to allow the AIFM and the AIF to have a timely and accurate situation of the accounts of the AIF; (g) the means and procedures by which the AIFM or the AIF will transmit all relevant information or will ensure the depositary has access to all the information it needs to fulfil its duties, including the procedures ensuring that the depositary will receive information from other parties appointed by the AIF or the AIFM; (h) information regarding the possibility for the depositary or a third party to whom safe-keeping functions are delegated according to Article 21(11) of Directive 2011/61/EU, to re-use the assets it was entrusted with or not and where relevant the conditions related to the potential re-use; (i) the procedures to be followed when a modification to the AIF rules, instruments of incorporation or offering documents is being considered, detailing the situations in which the depositary shall be informed, or where a prior agreement from the depositary is needed to proceed with the modification; (j) all necessary information that needs to be exchanged between the AIF, the AIFM, a third party acting on behalf of the AIF or the AIFM and the depositary related to the sale, subscription, redemption, issue, cancellation and repurchase of units or shares of the AIF; (k) all necessary information that needs to be exchanged between the AIF, the AIFM, a third party acting on behalf of the AIF or the AIFM and the depositary related to the carrying out of the depositary's oversight and control function; (l) where the parties to the contract envisage appointing	parties in accordance with prevailing laws and regulations; these obligations should not impair the ability of Member States competent authorities to have access to the relevant documents and information; 6. The means and procedures by which the depositary will transmit to the AIFM or the AIF all relevant information that the latter needs to perform its duties including the exercise of any rights attached to assets, and in order to allow the AIFM and the AIF to have a timely and accurate situation of the accounts of the AIF; 7. The means and procedures by which the AIFM will ensure the depositary has access to all the information it needs to fulfil its duties, including the process by which the depositary will receive information from other parties appointed by the AIF or the AIFM; 8. Information regarding the possibility for the depositary or a sub-custodian to re-use the assets it was entrusted with or not and where relevant the conditions related to the potential re-use; 9. The procedures to be followed when a modification to the AIF rules, instruments of incorporation or offering documents is being considered, detailing the situations in which the depositary should be informed, or where a prior agreement from the depositary is needed to proceed with the modification; 10. All necessary information that needs to be exchanged between the AIF, the AIFM and the depositary related to the sale, subscription, redemption, issue, cancellation and re-purchase of units or shares of the AIF; 11. Where the parties to the contract envisage appointing third parties to carry out their respective duties, an undertaking to provide, on a regular basis, details of any third parties appointed; and upon request, information on the criteria used to select the third party and the steps taken to monitor the activities carried out by the selected third party; 12. Information on the tasks and responsibilities of the parties to the agreement in respect of obligations	

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third parties to carry out parts of their respective duties, a commitment to provide, on a regular basis, details of any third party appointed; and upon request, information on the criteria used to select the third party and the steps envisaged to monitor the activities carried out by the selected third party; (m) information on the tasks and responsibilities of the parties to the contract in respect of obligations relating to the prevention of money laundering and the financing of terrorism; (n) information on all cash accounts opened in the name of the AIF or in the name of the AIFM on behalf of the AIF and the procedures ensuring that the depositary will be informed at the opening of any new account in the name of the AIF or in the name of the AIFM acting on behalf of the AIF; (o) details regarding the depositary's escalation procedure(s), including the identification of the persons to be contacted within the AIF and/or the AIFM by the depositary when it launches such a procedure;	relating to the prevention of money laundering and the financing of terrorism, where applicable; 13. Information on all cash accounts opened in the name of the AIF or in the name of the AIFM on behalf of the AIF and procedures by which the depositary will be informed at the opening of any new account opened in the name of the AIF or in the name of the AIFM on behalf of the AIF;	
(p) a commitment by the depositary to notify the AIFM when it becomes aware that the segregation of assets is not, or is no longer sufficient to ensure protection from insolvency of a third party, to whom safe-keeping functions are delegated according to Article 21(11) of Directive 2011/61/EU, in a specific jurisdiction; (q) the procedures ensuring that the depositary, in respect of its duties, has the ability to enquire into the conduct of the AIFM and/or the AIF and to assess the quality of information transmitted including by way of having access to the books of the AIF and/or AIFM or by way of on-site visits; (r) the procedures ensuring that the AIFM and/or the AIF can review the performance of the depositary in respect of the depositary's contractual obligations. 2. The details of the means and procedures set out in points (a) to (r) shall be described in the contract appointing the depositary or in a separate agreement. 3. The contract appointing the depositary and the agreement referred to in paragraph 2 shall be in writing.	14 Details regarding the depositary's escalation procedure(s), including the identification of the persons to be contacted within the AIF and / or the AIFM by the depositary when it launches such a procedure. The details of the means and procedures set out in paragraphs 1 to 14 should be described in this agreement or in the service level agreement or similar document. Subject to national law, there shall be no obligation to enter into a specific written agreement for each AIF; it shall be possible for the AIFM and the depositary to enter into a framework agreement listing the AIF managed by that AIFM to which it applies. The parties may agree to transmit part or all of this information electronically. Proper recording of such information shall be ensured. The agreement shall include the procedures by which the depositary, in respect of its duties has the ability to enquire into the conduct of the AIFM and / or the AIF and to assess the quality of information transmitted	New requirements have been introduced in the draft regulation, in comparison with ESMA advice.

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4. The parties may agree to transmit part or all of the information that flows between them electronically provided that proper recording of such information is ensured. 5. Unless otherwise provided by national law, there shall be no obligation to enter into a specific written agreement for each AIF; it shall be possible for the AIFM and the depositary to enter into a framework agreement listing the AIFs managed by that AIFM to which this agreement applies. 6. The national law applicable to the contract appointing the depositary and any subsequent agreement shall be specified.	including by way of on-site visits. It shall also include a provision regarding the possibilities and procedures for the review of the depositary by the AIFM and / or the AIF in respect of the depositary's contractual obligations. The law applicable to the agreement shall be specified.	
Article 88 *Monitoring of AIF's cash flows* The depositary shall ensure an effective and proper monitoring of the AIF's cash flows and in particular it shall at least: (a) ensure that all cash of the AIF is booked in accounts opened with entities referred to in Article 18 (1)(a) to (c) of Directive 2006/73/EC from the relevant markets where cash accounts are required for the purpose of the AIF's operations and which are subject to prudential regulation and supervision which have the same effect as Union law and are effectively enforced and in accordance with the principles set out in Article 16 of Directive 2006/73/EC; (b) ensure that there are proper procedures to reconcile all cash flow movements and verify that they are performed at an appropriate interval; (c) ensure appropriate procedures are implemented to identify immediately significant cash flows and in particular those which could be inconsistent with the AIF's operations; (d) review periodically the adequacy of those procedures including through a full review of the reconciliation process at least once a year and ensuring that the cash accounts opened in the name of the AIF, in the name of the AIFM acting on behalf of the AIF or in the name of the depositary acting on behalf of the AIF are included in	*Box 78* *Proper monitoring of all AIF's cash flows* To ensure the AIF's cash flows are properly monitored, the depositary should at least: 1. ensure the AIF's cash is booked in one or more cash accounts opened at an entity referred to in Article 18 (1) (a) to (c) of Directive 2006/73/EC or at a bank or credit institution of the non-EU market where cash accounts have been opened for the purpose of the AIF's operations; 2. ensure there are proper procedures to reconcile all cash flow movements and verify that they are performed at an appropriate interval; 3. ensure appropriate procedures are implemented to identify on a timely basis significant cash flows and in particular those which could be inconsistent with the AIF's operations; 4. review periodically the adequacy of those procedures including through a full review of the reconciliation process at least once a year and checking that the cash accounts opened in the name of the AIF, in the name of the AIFM acting on behalf of the AIF or in the name of the depositary acting on behalf of the AIF are included in the reconciliation process: 5. monitor on an ongoing basis the outcomes and actions taken as a result of any discrepancies identified by the reconciliation procedures and alert the AIFM	The draft regulation, in Article 88, says "effective and proper." This changes the depositary's duty. The ESMA advice in Box 88 refers to "properly monitored". Article 88 (a) makes reference to "prudential supervision" of an entity where cash accounts are opened. The ESMA advice Box 78 refers to "a bank or credit institution of the non-EU market". Article 88(c) increases the burden on the AIFM to "immediately" identify significant cash flows. ESMA and recital 91 say "timely basis".

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the reconciliation process; (e) monitor on an on-going basis the outcomes and actions taken as a result of any discrepancies identified by the reconciliation procedures and notify the AIFM if an irregularity has not been rectified without undue delay as well as competent authorities if the situation cannot be clarified and/or corrected; (f) check the consistency of its own records of cash positions with those of the AIFM. The AIFM shall ensure that all instructions and information related to a cash account opened with a third party are sent to the depositary, so that the depositary is able to perform its own verification or reconciliation procedure.	and/or the AIF if an anomaly has not been rectified without undue delay. 6. check the consistency of its own records of cash positions with those of the AIFM.	
Article 89 *Duties regarding subscriptions* The AIFM shall ensure that the depositary is provided with information about payments made by or on behalf of investors upon the subscription of units or shares of an AIF the moment the AIFM, the AIF or a party acting on behalf of it, such as a transfer agent receives the payments or an order from the investor. The AIFM shall ensure that the depositary gets all further relevant information it needs to make sure that the payments are then booked in cash accounts opened in the name of the AIF or in the name of the AIFM acting on behalf of the AIF or in the name of the depositary according to the provisions set out in Article 21(7) of Directive 2011/61/EU.		The wording of article 89 may require the depositary to be very closely linked with the subscription process. This is not in the ESMA advice as ESMA did not consider that a depositary should be required to make rectifications along the distribution channel.
Article 90 *Financial instruments to be held in custody* 1. Financial instruments belonging to the AIF or the AIFM acting on behalf of the AIF which are not able to be physically delivered to the depositary shall be included in the scope of custody duties of the depositary if they fulfil all of the following criteria: (a) They are transferable securities including those which embed derivatives in accordance with Article 51(3) final sub-paragraph of Directive 2009/65/EC and Article 10 of Directive 2007/16/EC, money market instruments or units of collective investment undertakings in accordance	*Box 79* *Definition of financial instruments to be held in custody - Article 21 (8) (a)* Pursuant to Article 21 (8) (a), financial instruments belonging to the AIF should be included in the scope of the depositary's custody function when they meet all the criteria defined below: 1. they are transferable securities (including those which embed derivatives in accordance with Article 51(3), final sub-paragraph of Directive 2009/65/EC and Article 10 of Directive 2007/16/EC), money market instruments or units of collective investment	The draft regulation does not incorporate ESMA's suggestions as regards collateral in Article 90. This is potentially extremely disruptive as it could also mean that all collateral is treated as being in custody: if so this would run counter to OTC practice. For stock lending, the custodian for collateral would have to be a sub-delegate of the custodian whereas currently their appointment is acknowledged along the lines of the position for prime brokers.

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with Annex I, Section C of Directive 2004/39/EC;	undertakings (as listed in Annex I, Section C of Directive 2004/39/EC) ; 2. they have not been provided as collateral under the terms of a title transfer financial collateral arrangement or under a security financial collateral arrangement by which the control or possession of the financial instruments within the meaning of Article 2(2) of Directive 2002/47/EC on financial collateral arrangements has been transferred from the AIF or the depositary to the collateral taker or a person acting on its behalf; and	
(b) They are capable of being registered or held in an account directly or indirectly in the name of the depositary. 2. Financial instruments which fulfil the criteria set out in paragraph 1 shall not be held in custody if they are only directly registered with the issuer itself or its agent, such as a registrar or a transfer agent, in the name of the AIF. 3. Financial instruments belonging to the AIF or the AIFM acting on behalf of the AIF which are able to be physically delivered to the depositary shall always be included in the scope of custody duties of the depositary.	3. they are registered or held in an account directly or indirectly in the name of the depositary. Financial instruments that are directly registered with the issuer itself or its agent (e.g. a registrar or a transfer agent) in the name of the AIF should not be held in custody unless they can be physically delivered to the depositary or the instrument is registered or held in an account directly or indirectly in the name of the depositary. Any financial instruments received as collateral for the benefit of the AIF should be regarded as having been 'entrusted to the depositary for safekeeping' within the meaning of Article 21 (8) (a) and therefore fall within the scope of its custody duties.	The draft regulation deviates from ESMA's advice in this regard.
	All financial instruments that do not comply with the above definition should be considered as 'other assets' under the meaning of the AIFMD Article 21 (8) (b) and be subject to record keeping duties.	The wording in article 90 on "other assets" as opposed to "assets held in custody" has been dropped, which makes the signposting less clear.
Article 93 *Reporting obligations for prime brokers* (c) the value of other assets referred to in Article 21(8)(b) of Directive 2011/61/EU held as collateral by the prime broker in respect of secured transactions entered into under a prime brokerage agreement, (d) the value of the assets where the prime broker has exercised a right of use in respect of the AIF's assets; (e) a list of all the institutions at which the prime broker holds or may hold cash of the AIF in an account opened in the name of the AIF or in the name of the AIFM acting	*Box 82* *Reporting obligations for prime brokers* 3(c) total collateral held by the prime broker in respect of secured transactions entered into under a prime brokerage agreement, including where the prime broker has exercised a right of use in respect of the AIF's assets;	ESMA advice does not require reporting to be split between total collateral held and where a right of use had been exercised over the assets.

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on behalf of the AIF according to Article 21(7) of Directive 2011/61/EU.		
Article 96 *Duties regarding the valuation of shares/units* 1. Compliance with Article 20(9)(b) of Directive 2011/61/EU entails that at least the following requirements shall be met, the depositary shall: (a) verify on an on-going basis that appropriate and consistent procedures are established and are applied to the valuation of the assets of the AIF in compliance with the requirements of Article 19 of Directive 2011/61/EU and its implementing measures and the AIF rules and instruments of incorporation; and	*Box 85* *Clarifications of the depositary's oversight duties* Duties related to the valuation of shares / units (b) 1. In order to ensure that the value of the units or shares of the AIF is calculated in accordance with the applicable national law, the AIF rules or instruments of incorporation and the procedures laid down in Article 19, the depositary should: a) verify on an-going basis that appropriate and consistent procedures are established for the valuation of the assets of the AIF in compliance with the requirements of Article 19 and its implementing measures and the AIF rules and instruments of incorporation; and	
(b) ensure that the valuation policies and procedures are effectively implemented and periodically reviewed. 2. The depositary's procedures shall be conducted at a frequency consistent with the frequency of the AIF's valuation policy as defined in Article 19 and its implementing measures. 3. Where the depositary considers the calculation of the value of the shares or units of the AIF has not been performed in compliance with applicable law or the AIF rules or the provisions of Article 19 of Directive 2011/61/EU, it shall notify the AIF/AIFM and ensure that timely remedial action is being taken in the best interest of the investors in the AIF. 4. Where an external valuer has been appointed, the depositary shall check that the external valuer's appointment is in accordance with the provisions of Article 19 of Directive 2011/61/EU and its implementing measures	b) ensure that the valuation policies and procedures are effectively implemented and periodically reviewed. 2. The depositary's procedures should be proportionate to the nature, scale and complexity of the AIF and conducted at a frequency consistent with the frequency of the AIF's valuation policy as defined in Article 19 and its implementing measures. 3. Where the depositary considers the calculation of the value of the shares or units of the AIF has not been performed in compliance with applicable law or the AIF rules or the provisions of Article 19, it should notify the AIF/AIFM and ensure timely remedial action has been taken in the best interest of the AIF's investors. 4. Where applicable, the depositary should be required to check that an external valuer has been appointed in accordance with the provisions of Article 19 of the AIFMD and its implementing measures.	The proportionality text in ESMA's advice is gone.
Article 100 *Due Diligence* 1. Compliance with the duties set out in Article 21(11)(c) of Directive 2011/61/EU requires that the depositary shall implement and apply an appropriate documented	*Box 89* *Due diligence Requirements*	

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due diligence procedure for the selection and on-going monitoring of the delegate. This procedure shall be reviewed regularly, at least once a year, and made available upon request to competent authorities.		
2. When selecting and appointing a third party, to whom safekeeping functions are delegated according to Article 21(11) of Directive 2011/61/EU, the depositary shall exercise all due skill, care and diligence to ensure that entrusting financial instruments to this third party provides an adequate level of protection. At least the following requirements shall be met:	1. When the depositary delegates any of its safekeeping functions, it should implement an appropriate, documented and regularly reviewed due diligence process in the selection and ongoing monitoring of the delegate. (a) When appointing a sub-custodian, the depositary should roll out a due diligence process which aims to ensure that entrusting financial instruments to a sub-custodian provides an adequate level of protection. Such a process should include at least the following steps:	This is a new standard of care and should be consistent with the reasonable standard of care ESMA proposes elsewhere in this paragraph and throughout its advice in order to ensure consistent and proportionate application.
(a) The assessment of the regulatory and legal framework including country risk, custody risk and the enforceability of the third party's contracts. This assessment shall particularly enable the depositary to determine the potential implication of an insolvency of the third party for the assets and rights of the AIF. In case that the depositary becomes aware that the segregation of assets is not sufficient to ensure protection from insolvency because of the law of the country where the third party is located, the depositary shall inform immediately the AIFM;	(i) assess the regulatory and legal framework (including country risk and custody risk). This assessment should particularly enable the depositary to determine the potential implication of the insolvency of the sub-custodian. Where the depositary becomes aware that the segregation of assets is not, or is no longer sufficient to ensure protection from insolvency of a sub-custodian in a specific jurisdiction, the depositary should notify the AIFM.	The requirement to assess enforceability of the third party's contracts does not appear in the ESMA recommendation. The new requirement is open-ended and, in some cases, may not be relevant or may be very difficult to do and would be costly. The requirement to assess "custody risks" would embrace this aspect.
(b) The assessment whether the third party's practice, procedures and internal controls are adequate to ensure that the financial instruments of the AIF or the AIFM acting on behalf of the AIF are subject to a high standard of care and protection. (c) The assessment whether the third party's financial strength and reputation are consistent with the delegated tasks. This assessment shall be based on information provided by the potential third party as well as other data and information, where available. (d) It shall be ensured that the third party has the operational and technological capabilities to perform the delegated custody tasks with a satisfactory degree of protection and security.	(ii) assess whether the sub-custodian's practice, procedures and internal controls are adequate to ensure the financial instruments will be subject to reasonable care. (iii) assess whether the sub-custodian's financial strength and reputation are consistent with the delegated tasks. This assessment shall be based on information provided by the potential sub-custodian as well as third party data and information where available. (iv) ensure the sub-custodian has the operational and technological capabilities to perform the delegated custody tasks with a satisfactory degree of protection and security requirements	The ESMA advice proposes a reasonable standard of care.

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3. The depositary shall exercise all due skill, care and diligence in the periodic review and on-going monitoring to ensure that the third party continues to comply with the criteria defined under paragraph 1 and the conditions set out under Article 21(11)(d) of Directive 2011/61/EU. To this aim the depositary shall at least: (a) monitor the third party's performance and its compliance with the depositary's standards;	(b) The depositary should perform ongoing monitoring to ensure the sub-custodian continues to comply with the criteria defined under §1 and the conditions laid out in Article 21 (11) (d), and at least. (i) monitor the sub-custodian's performance and its compliance with the depositary's standards;	This is a new standard of care and should be consistent with the reasonable standard of care ESMA proposes elsewhere in this paragraph and throughout its advice.
(b) ensure the third party exercises a high standard of care, prudence and diligence in the performance of its custody tasks and in particular that it effectively segregates the financial instruments in line with the requirements set out in Article 102;	(ii) ensure it exercises reasonable care, prudence and diligence in the performance of its custody tasks and particularly that it effectively segregates the financial instruments in line with the requirements set out in Box 90; and (iii) review the custody risks associated with the decision to entrust the assets to that entity and promptly notify the AIF or AIFM of any change in these risks. This assessment should be based on information provided by the sub-custodian as well as third party data and information where available. During unusual market conditions or where a risk has been identified, the frequency and the scope of the review should be increased. 2. The requirements in paragraph 1 apply mutatis mutandis to further sub-delegations by the sub-custodian. 3. The depositary should monitor compliance with the prohibitions in Article 21(4) of the Directive. 4. The depositary should design contingency plans for each market in which it appoints a delegate to perform safekeeping duties. Such a contingency plan may include the identification of an alternative provider, if any. The depositary shall take such measures, including terminating the contract, as are in the best interest of the AIF and its investors where the delegate no longer complies with the	The ESMA advice proposes a reasonable standard of care.
Article 102 *Loss of a financial instrument held in custody* 2. The ascertainment by the AIFM of the loss of a financial instrument must follow a documented process	*Box 91* *Definition of loss* 2. The assessment of the loss of financial instruments must follow a documented process available to	The ESMA advice included the concept of materiality in relation to notifications of lost assets.

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readily available to the competent authorities. Once a loss is ascertained it shall be notified immediately to investors in a durable medium.	competent authorities and lead to the notification of investors in a durable medium taking into account the materiality of the loss.	
Article 103 *External events beyond reasonable control* 1. (c) ... - assessing on an on-going basis whether any of the events identified under the first indent present a significant risk of loss of a financial instrument held in custody; and	*Box 92* *Definition of 'external event beyond the depositary's reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary* 3. (a) it has ensured that it has the structures and expertise that are adequate and proportionate to the nature and complexity of the assets of the AIF, to identify in a timely manner and monitor on an ongoing basis any external event it could reasonably identify which it considers may result in a loss of a financial instrument held in custody	The concept of the event being reasonably identifiable has been lost from article 103(1)(c).
(d) The requirements under points (a) and (b) may be deemed as fulfilled in the following situations but without being limited to: acts of God such as natural events beyond human control or influence; acts of State such as any law, decree, regulation or order of any government or governmental body, including any court or tribunal which impacts the financial instruments held in custody; war, riots or other major upheavals.	*External event* 26. ESMA has identified three types of event: • Acts of State or Acts of God • Events related to the insolvency of a sub-custodian • Other events including operational failures, fraud (…) 27. Taking into account Article 21 (12) and Article 21 (13), which state that the depositary's liability is not affected by the delegation of all or part of its custody function, ESMA suggests that, when assessing whether the event which caused the loss is external or internal, one should establish whether that event is external to the depositary and / or its sub-custodian (where the depositary has delegated the custody of the financial instruments to a third party). Consequently, ESMA proposes to consider that an event should be deemed 'external' if it did not occur as a result of an act or omission of the depositary or its sub-custodian where the financial instruments were held in custody. 28. In that framework, if the loss was due, for instance, to an accounting error or an operational failure at the depositary or its sub-custodian, that would be considered as an 'internal' event and would trigger the depositary's obligation to return a financial instrument of an identical type or a corresponding amount. Similarly, in case of a fraud which would have taken	This exceeds the ESMA advice. Article 103(1)(d) does not reflect the circumstances addressed in ESMA's explanatory statement which presumes only that the events are "internal". The draft regulation is much wider.

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	place within the depositary's network or one of its sub-custodians, the depositary would be held liable on similar grounds.	
Article 104 *Objective reasons for the depositary to contract a discharge of liability*	*Box 76* *Criteria for assessment of prudential regulation and supervision applicable to a depositary established in a third country* 1. For the purposes of the assessment provided for in Article 21 (6), the following criteria should be met: a. The entity should be subject to authorisation and on-going supervision by an independent competent authority with adequate resources to fulfil its tasks; b. The local regulatory framework should set out criteria for the eligibility to act as depositary that have the same effect as those set out for the access to the business of credit institution or investment firm within the EU; c. The capital requirements imposed in the third country should have the same effect as those applicable in the EU as set out in Article 21 (6) (b) depending on whether the entity is of the same nature as a credit institution or an investment firm; d. The operating conditions have the same effect as those set out for credit institutions or investment firms within the EU depending on the nature of the entity; e. The requirements on the performance of the specific duties as AIF depositary established in the third country regulatory framework have the same effect as those provided for in Article 21 (7) to (15) and in the relevant implementing provisions; f. The local regulatory framework provides for the application of sufficiently dissuasive enforcement actions in cases of breaches of the requirements of the AIFMD by the depositary; g. The liability of the depositary to the investors of the AIF can be invoked directly or indirectly through the AIFM, depending on the legal nature of the relationship between the depositary, the AIFM and the investors.	The draft regulation does not appear to deal with the criteria for assessing the prudential regulation and supervision of third country depositaries under Article 21(6). Box 76 of the ESMA advice has been omitted. The proposed article significantly exceeds the ESMA advice. The requirement for an objective reason for a contractual discharge of the depositary's liability is deemed fulfilled "where the law of a third country requires that certain financial instruments be held in custody by a local entity and there are local entities that satisfy the delegation criteria..." This appears to mean that, even though delegation to a sub-custodian who does not meet the Article 21(11) criteria is permitted in certain circumstances, there can be no contractual transfer of liability to such a sub-custodian.
1. The objective reasons for contracting a discharge pursuant to Article 21(13) of Directive 2011/61/EU shall	*Box 93* *Objective reasons for the depositary to contract a*	This text is not included in the ESMA advice and imposes a standard which does not appear in the Level

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be based on objective factors and shall be sufficient, consistent, coherent, compelling and justifiable. Objective reasons shall be understood as referring to precise and concrete circumstances characterising a given activity, which are capable, in a particular context, of justifying the discharge of liability by the depositary. The objective reasons must be established each time the depositary intends to discharge itself of liability.	*discharge*	1 directive.
2. There shall be objective reasons to contract discharge of the depositary's liability in accordance with Article 21(13) of Directive 2011/61/EU when: (a) the depositary can demonstrate that it had no other option but to delegate its custody duties to a third party; and (b) the AIF or the AIFM acting on behalf of the AIF has notified in writing the depositary that it considers the investment concerned by the delegation of custody to be in the best interest of the AIF and its investors. 3. The condition laid down in paragraph 2 point (a) may be deemed as fulfilled in the following indicative situations: (a) Where the law of a third country requires that certain financial instruments be held in custody by a local entity and there are local entities that satisfy the delegation criteria laid down in Article 21(11) of Directive 2011/61/EU; (b) Where the AIFM insists on maintaining an investment in a particular jurisdiction despite warnings by the depositary as to the increased risk this presents.	The depositary will be deemed to have an objective reason to contractually discharge itself of its liability in accordance with the requirements set forth in Article 21 (13) if it can demonstrate that: 1. it had no other option but to delegate its custody duties to a third party (e.g. as a result of legal constraints); or 2. the AIFM considers that it is in the best interest of the AIF and its investors for the depositary to discharge its liability and has notified the depositary of that assessment in writing).	The ESMA advice presents (a) and (b) as alternatives. The draft regulation presents them as cumulative tests. This will effectively make it impossible to discharge liability. It therefore appears to contradict the policy goals of the Level 1 text.
Chapter V Transparency requirements, leverage, rules related to third countries and exchange of information related to the potential consequences of AIFM activity		
Article 106 *Content and format of the balance sheet or statement of assets and liabilities and of the income and expenditure account* 1. The balance sheet or statement of assets and liabilities shall contain at least the following elements and underlying line items in accordance with Article 22(2)(a) of Directive 2011/61/EU:	*Box 105* *Primary Financial Statements required under Article 22 (2) (a) and (b) of Directive 2011/61/EU* Content and Format of the Balance Sheet (or Statement of Assets and Liabilities) 1. The balance sheet or statement of assets and liabilities shall contain at least the following elements and underlying line items, where applicable and where	ESMA's proportionality wording is missing.

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(a) 'Assets' comprising the resources controlled by the AIF as a result of past events and from which future economic benefits are expected to flow to the AIF. Assets shall be sub-classified according to the following line items: - 'Investments' including but not limited to debt and equity securities, real estate and property and derivatives; - 'Cash and cash equivalents' including, but not limited to, cash-in-hand, demand deposits and qualifying short term liquid investments; - 'Receivables' including, but not limited to amounts receivable in relation to dividends and interest, investment sold, amounts due from brokers and 'prepayments' including, but not limited to, amounts paid in advance in relation to expenses of the AIF. (b) 'Liabilities' comprising present obligations of the AIF arising from past events, the settlement of which is expected to result in an outflow from the AIF of resources embodying economic benefits. Liabilities shall be sub-classified according to the following line items: - 'Payables' including but not limited to amounts payable in relation to the purchase of investments or redemption of units or shares in the AIF and amounts due to brokers and 'accrued expenses' including but not limited to liabilities for management fees, advisory fees, performance fees, interest and other expenses incurred in the course of operations of the AIF; - 'Borrowings' including but not limited to amounts payable to banks and other counterparties; - 'Other liabilities' including but not limited to amounts due to counterparties for collateral on return of securities loaned, deferred income and dividends and distributions payable. (c) 'Net assets' representing the residual interest in the assets of the AIF after deducting all its liabilities. 2. The income and expenditure account shall at least contain the following elements and underlying line items: (a) 'Income' representing any increases in economic	<u>appropriate in relation to the type of AIF</u>: (a) 'Assets' comprising the resources controlled by the AIF as a result of past events and from which future economic benefits are expected to flow to the AIF. Assets shall, where appropriate, be sub-classified according to the following line items: (i) 'Investments' including but not limited to debt and equity securities, real estate and property and derivatives. This line item will depend on the nature and structure of the AIF and its investment profile; (ii) 'Cash and cash equivalents' including, but not limited to, cash-in-hand, demand deposits and, where applicable, other short term liquid investments; (iii) 'Receivables' including, but not limited to amounts receivable in relation to dividends and interest, investments sold, amounts due from brokers and 'prepayments' including, but not limited to amounts paid in advance in relation to expenses of the AIF. (b) 'Liabilities' comprising present obligations of the AIF arising from past events, the settlement of which is expected to result in an outflow from the AIF of resources embodying economic benefits. Liabilities shall be sub-classified according to the following line items where this is appropriate according to AIF type: (i) 'Payables' including but not limited to amounts payable in relation to the purchase of investments or redemption of units or shares in the AIF and amounts due to brokers and 'accrued expenses' including but not limited to liabilities for management fees, advisory fees, performance fees, interest and other expenses incurred in the normal course of operations of the AIF; (ii) 'Borrowings' including, but not limited to amounts payable to banks and other counterparties; (iii) 'Other liabilities' including but not limited to amounts due to counterparties for collateral on return of securities loaned, deferred income and dividends and distributions payable (c) 'Net Assets' representing the residual interest in the assets of the AIF after deducting all its liabilities. 2. The layout, nomenclature and terminology of line	

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benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increase in net assets other than those relating to contributions from investors. Income shall be sub-classified according to the following line items: (i) Investment income which can be further sub-classified as follows: - 'Dividend income' relating to dividends on equity investments to which the AIF is entitled; - 'Interest income' relating to interest on debt investments and cash to which the AIF is entitled; - 'Rental income' relating to rental income from property investments to which the AIF is entitled; (ii) 'Realised gains on investments' representing gains on the disposal of investments; (iii) 'Unrealised gains on investments' representing gains on the revaluation of investments; and (iv) 'Other income' including, but not limited to fee income from securities loaned and from miscellaneous sources. (b) 'Expenses' representing decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in net assets, other than those relating to distributions to investors. Expenses shall, be sub-classified according to the following line items: - 'Investment advisory/management fees' representing contractual fees due to the advisor or AIFM; and - 'Other expenses' including, but not limited to, administration fees, professional fees, custodian fees and interest. Individual items, if material in nature, should be disclosed separately. - 'Realised loss on investments' representing loss on the disposal of investment; - 'Unrealised loss on investments' representing loss on the revaluation of investments. (c) 'Net income/expenditure' representing the excess of	items should be consistent with the accounting standards applicable to or the rules adopted by the AIF, and comply with applicable legislation where the AIF is established. Such line items may be amended or extended to ensure compliance with the above. 3. Additional line items, headings and subtotals in the balance sheet or statement of assets and liabilities shall be presented when such presentation is relevant to an understanding of an AIF's financial position. Where relevant additional information shall be presented in the notes to the financial statements. The purpose of the notes is to provide narrative descriptions or disaggregation of items presented in the primary statements and information about items that do not qualify for recognition in these statements. 4. Each material class of similar items shall be presented separately. Individual items, if material, should be disclosed. Materiality should be assessed under the requirements of the accounting framework adopted. 5. The presentation and classification of items in the balance sheet or statement of assets and liabilities shall be retained from one reporting or accounting period to the next unless it is apparent that another presentation or classification would be more appropriate to the AIFM's reporting obligation, or because an accounting standard has required a change in presentation.	

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income over expenditure or expenditure over income as applicable. 3. The layout, nomenclature and terminology of line items should be consistent with the accounting standards applicable to or the rules adopted by the AIF, and comply with applicable legislation where the AIF is established. Such line items may be amended or extended to ensure compliance with the above. 4. Additional line items, headings and subtotals shall be presented when such presentation is relevant to an understanding of an AIF's financial position in the balance sheet or statement of assets and liabilities or an AIF's financial performance in the content and format of the income and expenditure account. Where relevant additional information shall be presented in the notes to the financial statements. The purpose of the notes is to provide narrative descriptions or disaggregation of items presented in the primary statements and information about items that do not qualify for recognition in these statements. 5. Each material class of similar items shall be presented separately. Individual items, if material, should be disclosed. Materiality shall be assessed under the requirements of the accounting framework adopted. 6. The presentation and classification of items in the balance sheet or statement of assets and liabilities shall be retained from one reporting or accounting period to the next unless it is apparent that another presentation or classification would be more appropriate, for example if a shift in the investment strategy leads to different trading patterns, or because an accounting standard has required a change in presentation. 7. With respect to the content and format of the income and expenditure account described in paragraph 2 all items of income and expense shall be recognised in a given period in the income and expenditure account unless an accounting standard adopted by the AIF requires otherwise.		
Article 109 *Remuneration disclosure*		In article 109(4) new disclosure requirements for relevant categories of staff to enable investors to assess

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4. AIFMs shall provide general information relating to the financial and non-financial criteria of the remuneration policies and practices for relevant categories of staff to enable investors to assess the incentives created. In accordance with the principles set out in Annex II (Remuneration Policy) of Directive 2011/61/EU. AIFMs shall disclose at least the information necessary to provide an understanding of the risk profile of the AIF and the measures it adopts to avoid or manage conflicts of interests.		incentives created, are referenced back to Annex II of Level 1. It is unclear how much this brings in all the details of the ESMA advice.
Article 113 *Use of Leverage on a 'Substantial Basis'* 1. Leverage is considered to be employed on a substantial basis for the purposes of Article 24(4) of Directive 2011/61/EU when the exposure of an AIF as calculated according to the commitment method under Article 10 exceeds two times its net asset value.	*Explanatory Text* 14. Leverage is a complex measure to calculate for the heterogeneous population of AIF covered by the AIFM Directive. As such, it is not deemed to be appropriate to seek to specify a quantitative threshold at which leverage would be considered to be employed on a substantial basis, as this may not always be the most insightful from the perspective of identifying systemic risk.	In paragraph 14 of the Explanatory Text under Box 111 of ESMA's advice it is stated that "it is not deemed to be appropriate to seek to specify a quantitative threshold at which leverage would be considered to be employed on a substantial basis". Accordingly, paragraph 1 wholly ignores ESMA's advice.
Article 116 *Modalities, instruments and procedures* 1. Cooperation arrangements shall provide the modalities, instruments and procedures required for ensuring the access of EU competent authorities to all information necessary for the performance of their duties under Directive 2011/61/EU. 2. Cooperation arrangements shall provide the modalities, instruments and procedures required for ensuring the ability to carry out on-site inspections where required for the exercise of the EU competent authority's duties under Directive 2011/61/EU. Onsite inspections shall be carried out directly by the EU competent authority or by the third country competent authority with the assistance of the EU competent authority. 3. Cooperation arrangements shall provide the modalities, instruments and procedures required for ensuring that the third country competent authority assists the EU competent authorities where it is necessary to enforce EU legislation and national	*Box 112* *Co-operation arrangements between EU and non-EU competent authorities* 1. The co-operation arrangement with the third country competent authority should be in writing and provide for: a. exchange of information for supervisory purposes; b. exchange of information for enforcement purposes; c. the ability to obtain all information necessary for the performance of the duties provided for in the Directive; d. the ability to carry out an on-site inspection where required for the exercise of the EU competent authority's obligations under the Directive. The on-site inspection should be performed directly by the EU competent authority or by the third country competent authority with the assistance of the EU competent authority. 2. The third country competent authority should assist the EU competent authorities where it is necessary to enforce EU legislation and national implementing legislation breached by the entity established in the	As stated above, in general, the language and drafting of the third country provisions makes it sound as though the text is creating obligations for competent authorities to enter into binding agreements with third country competent authorities. This would make it difficult to conclude such arrangements. The outcome of such a policy could endanger the effective operation of the third country regimes.

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implementing legislation breached by an entity established in the third country, in accordance with the national and international law applicable to that authority.	third country. 3. Where specific reference is made to exchange of information for the purpose of systemic risk oversight, the arrangement should allow the EU competent authority to receive information on a regular basis as provided for in Box 109 of ESMA's draft advice to the European Commission on possible implementing measures of the AIFMD in order to discharge its duties under the Directive. 4. The co-operation arrangements between EU and non-EU competent authorities as required by Articles 35(2), 37(7)(d) and 39(2)(a) of AIFMD should comply with paragraphs 1 to 3 above.	
Article 117 *Data protection* Cooperation arrangements shall ensure that the third country meets standards of data protection equivalent to those established in Articles 25 and 26 of Directive 1995/46/EC and that the transfer of data shall be only permitted under the conditions set out in Article 52 of Directive 2011/61/EU.		The wording from ESMA's explanatory text in Box 112 has not been carried across by the Commission into Article 117. Neither Article 52 of Directive 2011/61/EU, Articles 25 and 26 of Directive 95/46/EC, nor the final ESMA Level 2 guidance refer to an equivalence standard;