EUROPEAN PRIVATE EQUITY & VENTURE CAPITAL ASSOCIATION

On behalf of the Public Affairs Executive (PAE) of the
EUROPEAN PRIVATE EQUITY AND VENTURE CAPITAL INDUSTRY

17 January 2011

Private Equity and Venture Capital Industry Response to the CESR Call for Evidence on Implementing Measures on the Alternative Investment Fund Managers Directive (AIFMD, or the Directive)

The European Private Equity and Venture Capital Association (EVCA) welcomes the opportunity to respond to the Call for Evidence on Implementing Measures on the AIFMD published by CESR on 3 December 2010.

The questions put forward by CESR have been highlighted in bold and boxed out. EVCA's responses are set out in normal type.

Please note that the following responses are, due to the limited time available, only of preliminary nature and hence reflect only EVCA's initial thoughts and will need to be further looked into in order to ensure a more comprehensive answer.

EVCA remains, as ever, committed to an ongoing dialogue with policy officials and interested stakeholders, and welcomes any comment on its response to the consultation. In this respect, EVCA would particularly welcome the opportunity to meet with CESR/ESMA to explain and discuss its thoughts in more detail.

On a general note and as a starting point for all discussion around the questions put forward and when assessing the different approaches available we would strongly recommend a tailored approach taking into consideration amongst other the following differentiating factors inherent in the different types of AIFM and AIF and which already in themselves address some of the matters being addressed herein including risk control and investor protection:

- Is the relevant AIF an "off-the-shelf" product or based on a negotiated agreement?
- Is it customary for investors to do due diligence on the AIFM and its activities?
- Is the AIF managed and marketed an evergreen fund or of limited duration?
- Is the AIF of an open-ended or closed-ended nature?
- Is the AIF leveraged or non-leveraged?
- Is the AIF trading (in multiple (listed) securities that, from an investor point of view are largely fungible) on a daily basis or acquiring, holding and selling a specific type of asset and in very limited numbers (where each such holding in addition is unique from an investor point of view) over a longer time period?
- Do valuations provide the main basis on which fees are charged and remunerations based and on which investors trade units of the fund or not?
- Are interests with investors aligned?
- Is the relevant AIF a legal entity in itself or is "fund" merely used as a term to describe a series of contractual co-investment arrangements?

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These aspects should also call for caution when the UCITS Directive is used as a reference text as in several instances the intrinsic nature of AIF, their assets and their investors are different from the ones of the funds covered by the UCITS Directive.

A. DIFFERENTIATION

Which categories of investment manager and investment fund will fall within the scope of the Alternative Investment Fund Managers in your jurisdiction?

Please provide a brief description of the main characteristics of these entities (investment strategies pursued, underlying assets, use of leverage, redemption policy etc).

Response

This response relates to AIFM in their capacity as managers of venture capital and private equity (PE/VC) funds rather than to a particular jurisdiction. A number of the comments made below will also be relevant to some other types of fund managers and their respective funds, particularly those with illiquid asset classes, such as infrastructure and real estate, but also some others sharing the same structure.

The relevant underlying assets in a PE/VC fund are (i) generally, though not exclusively, shares and other equity related instruments in and (ii) occasionally debt securities in, loans to and other direct and indirect interests in or relating to:

- New and developing undertakings, both complete start-ups and innovative technology (e.g., green tech) businesses which may be either privately held or available to the public in junior markets;
- Undertakings where investment is made in order to assist in financing the venture and the development (or rescue) of its business, normally accompanied by rights of consultation, information or board representation;
- Management buy outs or buy ins or other business restructurings, which may include taking a publicly traded company, or a business owned by such a company, into private ownership;
- Other investments acquired with a view to, to facilitate or otherwise in connection with such investments.

These could include indirect investment via other companies, partnerships and undertakings (including special purpose vehicles), secondary acquisitions of interests originally acquired in transactions of the kinds described above, options or agreements to acquire interests in future (for instance when a family company is succession planning) or to dispose of them (for instance under management incentive programmes and target based arrangements where the management of a business increases its percentage holding as performance targets are met), instruments protecting against risks relating to exchange rates and interest fluctuations connected to an investment and investment via other funds (fund of funds and feeder funds).

Normally the bulk of the assets of a private equity or venture capital fund are illiquid. Even when some assets are potentially liquid (e.g., in public company shares) they will generally be acquired as a first step in pursuit of a longer term strategy than is normal for public market investors (e.g., a take private management buy out or the development of a technology or business) and the normal holding period for private equity and venture capital investments is greatly in excess of the normal holding period for public company investments[1].

[1] Please see the World Economic Forum paper, Stromberg P. (2008), “The New Demography of Private Equity, The Global Economic Impact of Private Equity Report 2008”.

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Private equity and venture capital are a specialist asset class (or rather ownership model turned asset class for institutional investors through their co-investment) dedicated to business growth[2]. Private equity and venture capital investors have a strong tendency to incentivise management and employees at both the investee company and the manager by reference to returns actually achieved and also received by investors (in cash or cash equivalent terms rather than on notional or valuation based measures).

Some features of PE/VC funds worth bearing in mind, in addition to their relative illiquidity, are that:

- PE/VC funds invest in active businesses with their own executive management (indeed helping to select, empower and professionalise appropriate management, while assisting with business and financial efficiency and discipline and development is a key feature of venture capital and private equity investment). Accordingly, although active engagement of the fund manager as shareholder representative is often important and beneficial, it is not a matter of taking frequent trading decisions or having to have day-to-day conduct of the business and assets. Instead the fund manager actively screens a large number of potential investment opportunities, some of which are pursued further involving, at the pre-investment stage, extensive negotiations, assessment and due diligence. The fund manager then structures and arranges the relatively few investment transactions (all relatively long term) which are actually made. It is then engaged in continuing shareholder support (which may include further agreed financial support and through sharing of know-how), monitoring and engagement of these portfolio companies, typically through board and committee representation, sometimes coupled with the provision of further advisory assistance in areas where the company concerned can be strengthened, e.g. add-on investments, geographic expansion etc.
- The private nature of the assets held, frequently coupled with restrictions on transfer, mean that it is difficult to "lose" them. There is a direct relationship with the investee company, which knows its shareholders/shareholder representatives. Even if a share certificate were to be lost[3], reference to the share register and the provision of appropriate warranties would normally enable its reissue.
- Throughout the life of a fund, private equity and venture capital AIF make a relatively small number of investments after extensive investigation and negotiation of the terms of investment. The investments are not then traded but are held until an exit, which may e.g. be a public offer or a negotiated trade sale. While investments of venture capital and private equity AIF are relatively few in number, they can be relatively complex in structure and nature, unlike the trading activity in listed and otherwise freely tradable securities of many other types of fund.
- Valuations of assets (interests in businesses) require intimate knowledge of both the asset/business and the market sector and matters of judgment unless or until a buyer is actually found for the asset concerned. Valuations of assets are inherently uncertain. It is accordingly very rare to base fees on valuations (except sometimes to reduce fees chargeable to investors) and investment returns to the manager are not payable based on unrealised increases in valuation but on actual returns received upon realisation of the fund investments.

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[2] Relevant research papers include “The Impact of Private Equity-backed Buyouts on Employee Relations” (2008) by EVCA/CMBOR; “How Do Private Equity Investors Create Value? A Study of 2006 Exits in the US and Western Europe” by Ernst & Young (2007).

[3] Share certificates are not issued in all Member States. E.g., in Sweden, a limited company no longer needs to issue share certificates. Where that is not the case, the share register (kept by the board) alone serves as evidence of who is the holder of the shares. Where issued, however, share certificates are “bearer instruments” and if lost must be cancelled through an official procedure, which takes six months – one year.

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The structures of private equity and venture capital deals are often complex, involving different groups of co-investors, and may hence involve a number of holding, intermediary and/or acquisition vehicles. Where such vehicles are created for purposes of a particular investment to avoid duplication and unnecessary costs, such vehicles should not be considered AIF in their own right. These arrangements do not constitute AIF as they do not have a defined investment policy which presupposes that the manager has discretion over the selection of investments in accordance with such policy but are created on an ad-hoc basis for the acquisition of specific assets without increasing the overall exposure of the investors in the AIF beyond their initial commitment.

Venture capital and private equity funds may take a number of different forms, including notably:

- a limited partnership (which may invest in parallel with other limited partnerships or vehicles, sometimes based in more than one jurisdiction, inside or outside the EU);
- a listed closed-ended investment company;
- a private closed-ended limited liability company;
- SICAR;
- and other collective investment schemes such as e.g. FCPRs.

However, the main international model for institutional investors is a closed-ended self liquidating limited partnership. This is also the model most commonly used by European fund managers, both small and large. It is particularly well suited to:

- the desire of professional investors in this field to negotiate in detail and amend the terms of the agreement applicable to their investment rather than simply accepting an investment product created and sold by the manager (and which is thus fundamentally different from investment categories and securities based on prospectuses and similar where investors have no influence at all on the applicable conditions);
- the long-term nature of the investment commitment;
- the focus on achieving business goals as part of the investment strategy;
- the alignment of the interests of investors with those of the manager and the individuals engaged in management; and
- tax transparency, so that each investor only pays tax directly in its own jurisdiction on the full amounts attributable to it from the investments made into [private] companies by the partnership just as it would when investing directly into listed shares or owning the private company directly.

The broad international use of a common tax transparent structure increases the efficiency (and hence lowers the cost for legal fees etc.) of investment activity for institutional investors. Common (though not universal, since each partnership is individually negotiated) features of such partnerships are:

- The partnership, although a business undertaking between the partners, is unlikely to be incorporated and may not have legal personality, depending on the jurisdiction of establishment.
- Each investor makes a commitment to fund the partnership's costs and investments up to a maximum individually agreed and stated fixed amount, which typically differs from investor to investor. The sum of these commitments constitutes the capital available for investment by the fund.
- Investors do not pay the manager the amount of their commitment at the time when they commit to the fund, but contractually commit to make payments up to the maximum

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stated amount as and when the manager “draws down” on the commitment in order to make specific investments or pay the fund’s expenses and costs.

- Just as investors pay in the amount committed as and when needed for investment, so will also amounts realised from investment (both income, which is normally low, and capital plus profits on disposals) be distributed back to investors when generated. Once a distribution is paid out in respect of committed capital, an AIFM rarely if ever has the power to draw down that committed capital again. To continue investing a PE/VC manager will need to raise a new fund once the preceding fund is close to being fully invested.

- The rolling nature of draw downs and distributions mean that the actual amount invested in a fund will vary from time to time.

- For the same reason, performance is generally measured on both a money multiple achieved to cost and an IRR (internal rate of return) basis, the latter taking account of time in the calculation of the return.

- An investment policy has between the fund and its investors been agreed for the fund including any required diversification, e.g. from a geographical perspective and restricting the percentage of the fund which can be invested in any one portfolio company, and sometimes during any specific year. As the long-term corporate development profile of private equity and venture capital investments, which makes the investments highly illiquid, does not fill the same function for investors as a liquid fund for normal securities investments (which are potentially traded on a frequent basis), risk diversification does not have the same salience for private equity and venture capital investors, who will – and who will want to – diversify their investment risks in other ways and on the basis of their own commercial judgement, and who will therefore have chosen the particular investment precisely for its risk profile.

- Borrowing is typically contractually prohibited at the fund level except generally to fund/bridge the period of waiting for investors to pay draw downs. Amounts borrowed at fund level for these purposes are typically for their duration applied against the commitments of investors, and do thus not increase the aggregate amount available for investments at fund level.

- A 10-year life span for the partnership, extendable by two consecutive periods of one year for each of which typically consent of investors or representatives of investors is required. There may also be continued management of investments for the purposes of disposing of them in the course of winding up the fund after it has come to the end of its life.

- An active investment period, generally up to 5 years, during which investors’ commitments can be drawn down for new investment. After that period, normally only certain "follow on" investments can be made to support existing investee companies, and the management focus is on continued monitoring and achieving a profitable exit for investors.

- The general partner in the fund (which is the only partner with unlimited liability for the obligations of the partnership) either acting as the manager or arranging for a member of its group (or theoretically a third party, although this is not normally permitted) to do so. The general partner (or the manager) receives a profit share or compensation typically calculated on a per annum basis by reference to the amounts committed to the fund, or part thereof. The calculation method may be altered (for instance to funds drawn down less distributions made) after the active investment period has ended but it is typically not valuation based (except where a drop in valuations generates a reduction of investors’ obligations to pay fees). If the manager is not the same as the general partner, then the general partner will generally be responsible for paying the manager's fees.

- The PE/VC fund managers (and/or the key investment executives) are required by the investors to share risk and co-invest with them in the fund. Subject to the fund meeting its “hurdle” return (typically 8 % in a PE fund) and the investors having received all their

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called capital back, plus expenses paid plus such hurdle return the manager (and/or the key executives) are normally entitled to 20% of the overall return made by the fund.

- Interests in a fund are not freely transferable. Typically, under certain strict conditions which vary from fund to fund, interests may be transferable but will at a minimum require the general partner/manager's consent to be granted at their discretion. Although there is now some secondary market for such interests, investors need to be ready to keep their interests in the fund for the whole life of the fund (although the amount involved will reduce as disposals and distributions of proceeds are made), and have to agree to the same when they commit to a fund.
- The fund documentation contains various restrictions aimed at avoiding conflicts of interest between the investors and the general partner/manager, e.g. ensuring that all co-investment is performed on a pro rata basis in all investments and restricting other investment activities and other business activities of key team members etc.
- Investors cannot be engaged in the management of the fund but will typically ask for an investors or advisory committee to be established under the partnership or investment agreement. Amongst other matters (such as valuation methodologies and consents to certain actions), this committee will be informed of and consulted on any conflicts of interest which may arise during the life of the fund.
- A (qualified) majority of investors can vote to terminate the investment period of the fund or even the fund itself prematurely or to replace the manager of the fund, e.g. if for any reason they lose confidence in the AIFM.

In terms of management structures, many venture capital and private equity managers are themselves small independent firms owned by their management. Although some are parts of larger banking or investment groups, most are not. In relative terms, the professional investors in private equity and venture capital funds are frequently very much larger than the manager and very well able to do due diligence on the manager and negotiate fund terms they require before making a commitment to a fund. The terms of the fund documentation are typically heavily negotiated between the manager of the fund and the professional investors, who are usually highly sophisticated investors with a multitude of investments in private equity and venture capital funds (on a global basis), represented by legal counsel and sometimes even more experienced than the fund sponsor itself. The other principal model for venture capital and private equity funds, though less prevalent, is the listed closed ended company which is, by virtue of its listing, available to retail investors as well as to private investors. These funds will also be closed ended, because of the illiquidity of the asset class and difficulty of valuation prior to exit. Unlike self-liquidating partnerships, they will normally be evergreen, with an indefinite life span, although it is possible for a listed fund to have a fixed winding up date. Some listed funds are either feeder funds into particular limited partnerships or funds of funds. They may gear or leverage at the level of the fund, though do not necessarily do so. Listed funds are typically (but not necessarily) structured as corporate vehicles with an independent board exercising control and supervision over the manager of the fund.

B. CHOICE OF LEGISLATIVE INSTRUMENT

Once CESR/ESMA has submitted its advice on the implementing measures, the Commission will have to decide which type(s) of legislative instrument would be appropriate for the level 2 measures. The choice is likely to be between directives – which require transposition at national level – and regulations, which are directly applicable on market participants without any national transposition. Regulations can be considered as promoting harmonisation across EU Member States (MS), while directives leave a greater amount of discretion to MS in their application. CESR may express an opinion on this in its advice to the Commission.

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Among the topics that will be covered by the implementing measures, which do you consider would be most appropriately adopted in the form of regulations or directives? Please explain your choice.

Response

- We believe that all topics to be covered by the implementing measures would be most appropriately addressed in the form of directives.

- This is because implementation via directives allows Member States, when transposing Level 2 directives into national law, to decide how to achieve the end result provided for in those directives. This is of absolutely key importance given the very broad range of AIF and AIFM covered by the AIFM Directive, the different populations of AIF and AIFM to be found across Member States and also the continuing evolution of fund structures and strategies.

C. IMPACT ASSESSMENT

In line with CESR's existing practices, the Commission mandate asks CESR to carry out an impact assessment (IA) as part of its advice. Ideally this IA work should quantify the compliance costs generated by CESR's proposals; input from stakeholders will be particularly important in facilitating such quantification.

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

Response

Through its different research activities and collection of data on the private equity and venture capital market on a European wide basis (via PEREP Analytics https://www.perepanalytics.eu/), EVCA remains at the disposal of CESR to provide further information. Additional information can also be provided through the EVCA network of national associations as well as through various reports, studies and papers published by independent academics and other bodies like the World Economic Forum.

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PART I

GENERAL PROVISIONS, AUTHORISATION AND OPERATING CONDITIONS

I. ISSUE 1 – ARTICLE 3 EXEMPTIONS

Opt-in

1. CESR is requested to advise the Commission on the procedures for AIFM which choose to opt-in under this Directive in accordance with Article 3(4). CESR should consider whether there are specific reasons not to use the same procedure that applies to AIFM that do not benefit from this exemption.

2. This advice should include procedures specific to the case of AIFM from third countries seeking to opt in after the phasing-in of the third country regime; in particular the determination of the Member State of reference.

Response

- We understand this question as aimed at determining the practical procedures by which AIFM below the threshold would opt into (i.e. become authorised under) the Directive.
- By allowing AIFM below the threshold to be partially exempt from the Directive, it is recognised that these AIFM pose particularly low risk to the financial system and that the costs of complying with the Directive in full would be disproportionate to the benefits of regulation. The wording of Article 3(5) implicitly recognises this in that it contemplates that the authorisation procedures for AIFM below the threshold may not be exactly the same as those for other AIFM.
- CESR should therefore consider how the opt-in authorisation process can be made proportionate for AIFM below the thresholds both in light of the lower risks posed and in light of the more limited resources of such AIFM. This might be achieved via dis-applying some of the information requirements for AIFM below the thresholds, or allowing greater flexibility to provide documentation (such as fund rules or instruments of incorporation) after the initial application for authorisation has been submitted. If the application process can be simplified, it would be appropriate to also require the competent authorities to process such simplified application more rapidly.
- As implied by the proportionality wording provided in the Level 1 Directive, ideally some of the requirements of the directive, while being required as such, should be adapted to the entities below the threshold that decide to opt in and due consideration should in this regard also be given to the differentiating factors as listed on page 1.

Threshold

1. CESR is requested to advise the Commission on how to identify the portfolios of AIF under management by a particular AIFM and the calculation of the value of assets under management by the AIFM on behalf of these AIF.

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2. The advice should identify options on how to determine the value of the assets under management by an AIF for a given calendar year. It should indicate the method or methods CESR regards as preferable.

3. CESR is invited to consider how the use of different forms of leverage influences the assets under management by an AIF and how this should best be taken into account in the calculation of assets under management.

4. CESR is requested to advise the Commission on how best to deal with potential cases of cross-holdings among the AIF managed by an AIFM, e.g. funds of AIF with investments in AIF managed by the same AIFM.

5. CESR is requested to advise the Commission on how to treat AIFM whose total assets under management occasionally exceed and/or fall below the relevant threshold in a given calendar year. As part of this work, CESR is requested to specify circumstances under which total assets under management should be considered as having occasionally exceeded and/or fallen below the relevant threshold in a given calendar year.

6. CESR is requested to advise the Commission on the content of the obligation to register with national competent authorities for the entities described in Article 3(2).

7. CESR is requested to advise the Commission on suitable mechanisms for national competent authorities in order to gather information from these entities in order to effectively monitor systemic risk as set forth in Article 3(3). To that end, CESR is requested to specify the content, the format, and modalities of the transmission of the information to be provided to competent authorities. CESR is invited to consider the consistency with its advice regarding the Issue 25 (reporting obligations to competent authorities).

8. CESR is requested to advise the Commission on the obligation of AIFM to notify competent authorities in the event they no longer comply with the exemptions granted in Article 3(2).

<u>**Response**</u>

- There is no single accepted method for determining the value of "assets under management" by private equity or venture capital firms. Taking into account that private equity and venture capital funds are closed-ended with no redemption rights and undertake long-term investments, it is legitimate to use a method protecting private equity and venture capital managers from any yo-yo effect and investors from uncertainty regarding the application of the Directive.

- The value of a typical private equity or venture capital fund also works differently to that of a typical UCITS fund, for a number of reasons:

  - *UCITS are open-ended, meaning that the value of assets under management can increase through new subscriptions and reduce through cancellation of units/shares.* Private equity and venture capital funds are closed ended, so these fluctuations do not occur.

  - *When investors purchase units or shares in a UCITS, they pay on the date of purchase an amount corresponding to the value of the unit or share.* Investors in typical private equity and venture capital funds **do not do this**. Instead of paying for an interest in the fund at the outset, they agree at the outset to commit to pay an amount into the fund over its life. This means there is no commercial requirement to identify a net asset value for the investment at the time of commitment, as it would be meaningless. The investor pays his investment into the fund during the life of the

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fund, as and when investments are made or the fund needs to cover its expenses. This commitment structure is designed for the benefit of the investor, because it allows the investor to keep his money until that money is required by the fund. This means a fund will "draw down" the commitment from investors over a number of years. A fund will typically make investments over a fixed number of years (typically the first five years of the fund), known as the investment period. Managers and general partners are not required to draw down all of the funds committed by investors over the life of the fund.

  - *A UCITS fund is normally established to be perpetual, so that investors can only receive the value of their investment through dividends or selling their investment, This means there is normally a liquid market in fund interests.* Private equity and venture capital investors know at the point of investment that the fund life is limited. The purpose of the fund is to purchase interests in portfolio companies, and in each case hold the investment for a period before selling it. When a portfolio company is refinanced or sold, the proceeds are normally paid out to investors immediately. (These proceeds may not be paid out immediately where this cash is used to support business expansion by companies owned by the fund, but would be paid when the investment is ultimately sold). It normally takes a number of years (typically another five years after the end of the investment period) to sell all the fund investments and repay the investors in full, at which point the fund is wound up.

- There are accordingly a number of possibilities for calculating the value of assets under management, including:

  - *Acquisition cost of assets held.* This reflects the purchase price of investments held by the fund. It accordingly reflects the amounts actually drawn down from investors, less expenses paid by the fund and amounts returned to investors following the sale or refinancing of portfolio companies. This amount accordingly is a close representation of the amounts actually invested by the investors. Accordingly at the launch of a fund, the maximum value of the acquisition costs is typically reasonably foreseeable.

  - *Value of commitments less realisations at cost.* This represents the amount committed by an investor at the outset of a fund less amounts realised. Draw-downs against commitments are typically made over a five year period “the investment period” after which further draw-downs are typically only permitted to fund development of existing investments. The committed amount may never be fully drawn down. Realisations of the investments typically commence towards the end of the investment period.

  - *Value of assets held*. This is net value of investments remaining in the portfolio and accordingly reflects the value of investments purchased less expenses paid by the fund and amounts returned to investors following the sale or refinancing of portfolio companies.

  - This use of cost of investment would most closely represent the amount actually invested by investors in a private equity fund at all stages of the fund. It would also enable the maximum potential value of the fund to be determined at the outset and therefore enable the AIFM and investors in its AIF to determine the likelihood that the fund will fall within the directive over the course of the investment period.

  - The use of the value of assets held would most closely represent the value of an investor’s investment in a private equity fund. The use of this method could result in a yo-yo effect whereby the AUM could fluctuate above and below the threshold, particularly in the case of funds investing in start-ups or highly innovative companies where paper values can fluctuate immensely when based on comparable listed companies or recent transactions. This, together with the fact that the estimated value of assets during the life of a fund may not be representative of the ultimate value of

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the assets realised on a private sale, would require the AIFM to assess whether any such fluctuations are genuinely material to its ongoing compliance with the threshold criteria. It would be highly disproportionate, and inconsistent with commercial reality if occasional fluctuations above or below the threshold were materially to change the AIFM's regulatory status (i.e., by removing the possibility for the AIFM to benefit from the exemption). AIFM could (for example) consider the frequency of such fluctuations, their duration and size and the likelihood that the value of the portfolios will return below the threshold. The notification requirement under Article 3(3)(e) should accordingly apply where there are reasonable grounds to believe that the AIFM no longer complies with the threshold criteria, taking these factors into account.

- o The use of commitments reduced by realisations would enable the size of the fund to be determined at the outset and would represent the maximum potential exposure for an investor at any stage during the life of the fund. However as AIFM would typically commence realisations prior to the end of an investment period it would avoid the potential for double-counting of AUM which might otherwise occur if commitments were used for the life of the fund, as AIFM generally have to raise a new fund at the end of the investment period.

- An AIF whose manager expects to be subject to the Directive is likely to incur higher expenses to meet the costs of compliance with the Directive (including the costs of paying the depositary). These costs will ultimately be borne by investors and are likely to impact more heavily on the managers of smaller AIF. It is therefore important for AIFM and their investors that where they are below the threshold for full registration that appropriate measures are implemented to ensure that increases in AUM that would bring it above the threshold only temporarily will not result in a requirement for full registration and therefore additional significant unnecessary cost. It will also be important that sufficient timescales are allowed for AIFM, who are initially not subject to full registration, to comply fully where increases in AUM brings it above the threshold permanently.

- The portfolios of AIF under management by a particular AIFM for purposes of the thresholds should comprise all those portfolios of assets within AIF of which the AIFM is the AIFM. It should not include any other portfolios "managed" by the AIFM for purposes of the Directive. Accordingly, it should include portfolios of an AIFM, the management of which has been delegated to a third party discretionary manager. However, portfolios managed by an AIFM as a delegate for another AIFM or on a discretionary basis (e.g., under the Markets in Financial Instruments Directive (2004/39/EC) (“MiFID”)), but for which it is not the AIFM for purposes of the Directive, should not be caught.

- Clearly, there should be no double counting of cross-holdings.

- The relevant portfolios should only be those in relation to which the AIFM would (but for the threshold) fall within the scope of the Directive. So, for example, non-EU AIF managed by a non-EU AIFM that are not marketed in the EU should not form part of the calculation of assets under management for these purposes.

- A seasoned PE/VC firm will typically have three funds in parallel under management, in most cases with separate fund managers. Fund 1 will be in realisation mode with a few remaining investments under management. Fund 2 will be at the tail-end of its investment period and having started to realise investments. Fund 3 will have been recently raised and only starting to make draw-downs and investments.

- The minimum content requirements for registration with the competent authorities by AIFM below the thresholds are already specified in Article 3(3). The Commission should not therefore increase these requirements at Level 2. Rather, the Level 2 measures should be limited to addressing practical matters relating to the registration.

- The frequency of reporting under Article 3(3)(e) should take account of different types of AIF and AIFM. In areas that present low or no systemic risk, such as venture capital and

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private equity, a lower reporting frequency (e.g. annual reporting) should suffice.

- As AIFM that are subject only to registration will not benefit from any rights granted by the AIFMD, the registration procedure should be as straightforward and minimal in scope as possible, with a view to reporting on systemic risk issues. Therefore, as indicated in Article 3(3) of the AIFMD, the registration should amount to presentation to the competent authorities of the basic information on the AIFM and the AIF: (a) registration information of AIFM and AIF (names, registered numbers, addresses); (b) contact details for AIFM and AIF; (c) investment strategies of AIF and (d) details for an individual contact at the AIFM (name/surname, address, responsibility within the AIFM.

II. ISSUE 2 – ARTICLE 9 INITIAL CAPITAL AND OWN FUNDS

1. CESR is requested to provide the Commission with a description of the potential risks arising from professional negligence to be covered by additional own funds or the professional indemnity insurance referred to in Article 9(7).

2. CESR is requested to advise the Commission on how the appropriateness of additional own funds or the coverage of the professional indemnity insurance to cover appropriately the potential professional liability risks arising from professional negligence referred to in Article 9(7) should be determined, including – to the extent possible and appropriate – the methods to calculate the respective amounts of additional own funds or the coverage of the professional indemnity insurance.

3. CESR is requested to advise the Commission on the best way to determine ongoing adjustments of the additional own funds or of the coverage of the professional indemnity insurance referred to in Article 9(7).

4. CESR is invited to take account of work done in the context of the Capital Requirements Directive and to liaise as appropriate with CEBS and CEIOPS on this issue.

<u>Response</u>

- Articles 7 and 8 of the Capital Adequacy Directive (2006/49/EC) ("CAD") impose professional indemnity insurance requirements on certain types of investment firm subject to MiFID. The European Commission reviewed the appropriateness of those Articles in 2007, as required under Article 65(6) of MiFID. The results of that review are set out in a concise report, COM (2007) 178. In summary, the Commission concluded that there was no need to alter the existing provisions.

- CAD Article 7 applies to certain investment firms which are not subject to the insurance mediation directive, whose MiFID services are limited to investment advice and reception and transmission of orders and do not hold client money or assets. Such firms are required to have one of the following:

  - Initial capital of EUR 50,000;
  - Professional indemnity insurance covering the whole of the territory of the Community, or some other comparable guarantee against liability arising from professional negligence, with a level of indemnity of at least EUR 1,000,000 for a single claim and, in aggregate, EUR 1,500,000 per year;
  - A combination of initial capital and professional indemnity insurance in a form resulting in a level of coverage equivalent to either of the above.

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- We note that in some respects, these firms are similar to AIFM:

    - o Neither type of firm may act as a depositary, so that the risk for a client in each case is the risk of negligent decision making rather than negligent loss of assets;
    - o Both types of firm are limited to providing fiduciary services (rather than investing own funds);
    - o Both types of firm are subject to detailed conduct of business requirements;
    - o Both types of firms are eligible for the passport where they fulfil the relevant conditions.

- We also note some differences:

    - o Firms falling within CAD Article 7 are entitled to provide services to consumers under MiFID. AIFM have no such rights under the Directive.
    - o AIFM are subject to much higher own funds requirements, in addition to the requirement to hold professional indemnity insurance ("PII"). Firms falling within CAD Article 7 have a maximum own funds requirements of EUR 50,000.

- We recommend that the Commission examine the costs for the industry (and hence ultimately to investors) of introducing a requirement for AIFM based on the requirements set out in CAD Article 7.

- We note that CAD does not set out the risks to be covered by PII and this will be a new requirement for financial services firms.

- We note that there have been periods when due to market conditions, it has become impossible to obtain PII or where the cost of obtaining PII has become prohibitive. The Commission's report referred to above (COM (2007) 168) also refers to this. We would advocate PII requirements which confer flexibility on competent authorities to temporarily waive the requirements in such circumstances.

- We do not comment on the level of own funds which might be held as an alternative to professional indemnity insurance. We note that the alternative offered by CAD Article 7 is EUR 50,000. We would welcome discussions with ESMA regarding the appropriate amount before publication of any firm numbers.

- We note that Article 65(6) of MiFID required the Commission to report within two years of that Directive coming into force on the appropriateness of the level of PII. We suggest that ESMA also performs a review and reports on its findings to the Commission two years after the coming into force of the Directive.

III. ISSUE 3 – ARTICLE 12 GENERAL PRINCIPLES

1. CESR is requested to advise the Commission on criteria to be used by the relevant competent authorities to assess whether AIFM comply with their obligations under Article 12(1).

The Commission would encourage CESR to target an appropriate level of consistency with the corresponding provisions of other directives, such as UCITS and MiFID, while taking due account of the differences between the regulated populations.

<u>Response</u>

We believe there is some scope to use corresponding provisions in other directives, such as UCITS and MiFID as the basis for determining the criteria to be used by competent authorities under AIFMD. However, it is of vital importance that this is not achieved by means of mere

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"copy-out". The UCITS Directive, in particular, regulates a specific brand of fund targeting retail investors. It is neither appropriate nor proportionate to assume that the same requirements should apply to AIF, which are closed and/or whose investors are professionals. Under MiFID rules, the customer classification provisions provide for appropriate differentiation in terms of disclosures in respect of the customers' level of financial sophistication. Given the nature of private equity and venture capital investments – which are not, and which AIFMD does not envisage them to be – retail savings products, it would seem appropriate not to compare private equity and venture capital fund structures to UCITS funds but rather look to other types of illiquid investments, in particular as they may be marketed and sold to qualified investors (in terms of the Prospectus Directive's prospectus exemptions) and (in MiFID terms) professional investors or eligible counterparties.

IV. ISSUE 4 – ARTICLE 14 CONFLICTS OF INTEREST

1. CESR is requested to provide the Commission with a description of the types of conflicts of interests between the various actors as referred to in Article 14(1).

2. CESR is requested to advise the Commission on the reasonable steps an AIFM should be expected to take in terms of structures and organisational and administrative procedures in order to identify, prevent, manage, monitor and disclose conflicts of interest.

The Commission would encourage CESR to target an appropriate level of consistency with the corresponding provisions of other directives, such as UCITS and MiFID, while taking due account of the differences between the regulated populations.

<u>**Response**</u>

As a general comment, we would like to stress that conflicts of interests are typically within the focus of due diligence of potential PE/VC investors, who usually negotiate strict clauses to ensure disclosure of any kind of conflict of interest and approval requirements by the investor committee (a standard feature for most PE/VC funds) in case a conflict arises.

- In order to provide the Commission with a description of the types of conflicts of interests between the various actors as referred to in Article 14(1), CESR should consider IOSCO's November 2010 Final Report on Private Equity Conflicts of Interest (accessible here: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD341.pdf).

- Some conflicts of interest which may potentially arise in other areas of the asset management industry are not relevant in a PE/VC context. For example, potential conflicts arising where fund managers receive fees based on unrealised or "paper" gains determined by the managers themselves (or their employees receiving remuneration based on such unrealised gains) do not arise since PE/VC managers (and their staff) are compensated based on investors' IRRs rather than on unrealised gains.

- EVCA therefore respectfully recommends that CESR advise the Commission that procedures to protect against conflicts of interest in the alternative investment sector cannot be generalised, but should be tailored to different AIF business models. As noted in our response to Issue 3 above, we believe there is some scope to use corresponding provisions in other directives (such as UCITS and MiFID) as the basis for the Level 2 measures under AIFMD, but this must not be achieved via mere "copy-out".

- CESR should also note that conflicts issues are a key focus for investors. Private equity and venture capital fund managers' conflicts management arrangements are very carefully negotiated by investors in the fund documentation. For example, investors may require specific arrangements to be in place (such as manager co-investment arrangements) in order to align the interests of the private equity and venture capital fund

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and its investors with those of the AIFM and key staff. Any Level 2 measures developed in this area should generally respect these negotiated mechanisms.

V. ISSUE 5 – ARTICLE 15 RISK MANAGEMENT

1. CESR is requested to advise the Commission on the risk management systems to be employed by AIFM as a function of the risks that the AIFM incurs on behalf of the AIF that it manages and on the criteria that competent authorities should take into account when assessing for the AIF managed by the AIFM whether the risk management process employed by the AIFM is adequate in order to identify, measure, manage and monitor appropriately all risks relevant to each AIF investment strategy and to which each AIF is or can be exposed.

Response

As a general point we believe that considerable caution should be exercised in producing Level 2 measures setting out detail on risk management systems, since although we strongly support careful risk management, we believe there is a real risk that detailed regulation on the subject may narrow the focus of risk management to only those aspects which can be readily identified in the compliance matrix generated from the regulations, rather than genuinely monitoring appropriately the risks of the relevant fund.

A number of the questions posed by the Commission, and comments on the approach to be taken to risk management, tend to suggest that it has in mind a hedge fund or other active participant in the traded financial markets and the types of risk, and potential for risk management, inherent in that type of strategy.

With respect to private equity and venture capital AIF, it should be noted that the investment agreement negotiated with the investors sets out the investment strategy as such and also typically governs certain limitations of risk as maximum percentage of the fund to be invested in any one asset/company. The AIFM team can be very small, sometimes consisting of not more than five (or even less) Principals who have extensive experience and knowledge in analysing investments in potential portfolio companies and also in actively monitoring such companies. It is therefore such team that is best suited to make a decision on whether the investment has potential and also in negotiating the terms of the acquisition (and sale). Once the investment is made, the AIF will hold the investment for many years (typically three to five years), as the idea is to create and build companies with long term value creation potential making them attractive to potential buyers. These investments are illiquid and not easily realisable. The ongoing monitoring is part of the portfolio management process. Hence, the primary focus of "risk management" for a PE/VC firm is typically in the investment (and divestment phase). The particularity is here that portfolio management team having identified portfolio companies and monitored them for years is best suited to identify any potential risks. Investors will in their due diligence also focus on the investment team, their background, track-record and experience and will review the investment and decision making processes, which can vary between firms due to investment stage, investment size and geographical reach.

In particular, CESR is requested:

a) to advise on the categories of risk relevant to each AIF investment strategy and to which each AIF is or can be exposed and the methods for identifying the risks that are relevant for the particular AIF investment strategy or strategies so that all risks are adequately identified.

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Response

Any Level 2 measures which are produced should be tailored enough to fully recognise the different asset classes and types of investment and investment strategy. Extensive work has identified the generally low-risk nature of private equity investment and the fact that risks incurred tend to be non-systemic. Although investment in individual companies, particularly start ups, companies in need of venture and development capital and distressed companies, may be high risk, those risks are reduced rather than increased by the professional management and risk spreading achieved by investing through a fund (which typically makes a limited number of investments throughout its life) in which management incentives are aligned with the interests of investors (through co-investment/profit sharing mechanisms).

Some consideration may need to be given to how far general economic risks, and market sector risks, must be identified and measured when a particular fund is required by its investment policy to invest in a particular jurisdiction or market sector and how far such risks are a matter for disclosure in the pre-investment documentation to assist professional investors in deciding in how much of their portfolio they wish to invest in the sector which is subject to those risks.

Specifically, categories of risk usually associated with other types of alternative investment are set out below, together with observations on the characteristics of AIF for which each issue may be relevant:

- Credit risk: Relevant to an AIFM's risk management policy with regard to an AIF to the extent that the AIF's assets consist of contractual rights and the value of those rights depends on the creditworthiness of the AIF's counterparties.

- Currency risk: Relevant to an AIFM's risk management policy with regard to an AIF to the extent that the AIF's assets are denominated in a currency other than the financial reporting currency of the AIF. In such cases, the AIFM should consider whether its risk management policy should include hedging against such currency risks. In general, the longer the AIF's investment horizon, the less likely it is that such hedging would be necessary or appropriate as part of the AIF's risk management policy. There would be typically full disclosure in the PPM.

- Market risk: Relevant to an AIFM's risk management policy with regard to an AIF to the extent that the AIF may in practice be required to liquidate assets at a time outside its control,.

- Systemic risk: Relevant to an AIFM's risk management policy with regard to an AIF to the extent that the AIF's assets consist of contractual rights and the value of those rights would likely be negatively and materially affected by obligations of the AIF's counterparties to counterparties under contracts to which the AIF is not party.

EVCA notes that because of the particular features of private equity and venture capital AIF, none of these risks are likely to be significant in the context of such PE/VC funds, and even less significant in the context of a fund of funds. EVCA respectfully recommends that ESMA note that the measures to be taken by AIFM to separate risk management functions; to safeguard against conflicts of interest; to ensure due diligence in an AIF's investments; and to ensure "appropriate" stress testing should take account of the extent to which an AIF is exposed to these risks and avoid requiring measures that would be disproportionate in the particular context of PE/VC business models and which would be neither proportionate nor justified from investors' point of view.

b) to advise, to the extent possible, on methods for quantifying and measuring risks including the conditions for the use of different risk measurement methodologies in relation to the identified types of risk so that overall risk exposures as well as contributions to overall risk from each risk factor are properly measured.

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Response

See above.

c) to advise on adequate methods for managing and monitoring all such risks so that the AIF risk exposures respect at all times the risk objectives of the AIF.

Response

We are not entirely sure what this question means. A private equity or venture capital fund will not normally have "risk objectives" though the investment policy may include some restrictions. See also above.

2. CESR is requested to advise the Commission on the appropriate frequency of review of the risk management system. CESR is invited to consider whether the appropriate frequency of review varies according to the type of AIFM or the investment strategy of the AIF.

Response

We respectfully suggest that ESMA recommend to the Commission that the frequency of review of risk management systems should depend on the extent to which AIF following particular business models are subject to the types of risk outlined above and to their investment cycles. Frequent reviews of risk management systems or "stress-testing" are not appropriate or relevant for AIF that make medium to long term illiquid investments of the kind made by venture capital and private equity funds. See also above.

3. CESR is requested to advise the Commission on the conditions for the appropriate risk governance structure, infrastructure, reporting and methodology, in particular, on how the risk management function shall be functionally and hierarchically separated from the operating units, including the portfolio management function.

Response

Whilst the Level 2 measures have no power to change the Directive requirement for functional and hierarchical segregation of risk management and portfolio management, we note the express reference in Article 15(1) to the principle of proportionality. The Directive text recognises that "functional and hierarchical" separation of risk management from portfolio management may not be proportionate for some AIFM and allows this requirement to be dis-applied, provided there are adequate safeguards against conflicts of interest so that the risk management is independent, the AIFM's risk management process is effective, and the AIFM complies with the other requirements of Article 15. This flexibility is very important to venture capital and private equity firms, as set out below.

We believe it would be a dereliction of duty for the portfolio managers who are engaged in investigating potential investments, taking decisions to acquire and dispose of investments and conducting ongoing monitoring, and are the persons with the most intimate and detailed knowledge of the investee companies, to fail to consider and seek to manage risk when acting as portfolio managers. This is necessary not only when deciding whether to invest but also in negotiating the terms of investment (and divestment), since among the tools for measurement and management of risk are the reporting and consent requirements, board and other representation and rights obtained in relation to the investee company, together with the warranties and indemnities received or given on acquisition/sale. The qualifications and experiences of these investment executives are crucial and determining factors for investors choice of PE/VC fund managers.

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A functionally and hierarchically separate risk management function will not be in a position to assess and negotiate such provisions, nor to monitor the investment in the same way as the portfolio managers can do. There is therefore likely to be a degree of duplication or internal audit involved in any segregation of risk management in relation to venture capital and private equity. The risk management function should not end up duplicating the portfolio management function, nor discouraging the latter from being fully mindful of, and seeking to manage, risk.

As a general point, the concept of "hierarchical" separation is quite unclear and should be clarified. To the extent it relates to relative seniority within the AIFM, it should be borne in mind that many venture capital and private equity managers are small organisations owned by their management. In such organisations complete hierarchical segregation is not feasible because, for instance, some or all members of the Investment Committee which takes portfolio management decisions are likely also to be on the governing body of the manager and probably also shareholders/partners in the firm.

For these reasons it will be disproportionate for many venture capital and private equity AIFM to functionally and hierarchically separate risk management from portfolio management. These firms should instead be able to demonstrate adequate safeguards against conflicts of interest, for example through co-investment and profit sharing mechanisms and other conflicts management mechanisms negotiated with investors in the fund documentation. The risk management function's role should therefore be restricted to one of oversight, checking that portfolio managers are following the AIFM's risk management requirements. Again, however, this needs to be proportionate and take account of the size and nature of the AIFM and the risks undertaken by the AIF.

We therefore respectfully suggest that ESMA recommend to the Commission that the governance structures required for AIF following particular business models should depend on the extent to which such AIF are subject to the types of risk outlined above and to their investment cycles. Complex governance structure, infrastructure, reporting and methodology, would not be proportionate for AIF that make medium to long term illiquid investments of the kind made by venture capital and private equity funds and that have been recognised as not having contributed to the current financial crisis. See above.

4. CESR is requested:

a) to advise how the principle of proportionality is to be applied by competent authorities in reviewing the functional and hierarchical separation of the functions of risk management in accordance with Article 15(1).

Response

See comments above.

b) to advise on criteria to be used in assessing whether specific safeguards against conflicts of interest allow for the independent performance of risk management activities and that the risk management process satisfies the requirements of Article 15 and is consistently effective. This advice will be particularly relevant in cases where full separation of functions is not considered proportionate. CESR is encouraged to provide the Commission with a non-exhaustive list of specific safeguards AIFM could employ against conflicts of interest referred to in the second subparagraph of Article 15(1).

Response

The limited partnership and co-investment/profit sharing model have built into them a strong safeguard against conflicts of interest by incentives and returns to

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the manager (and investment executives) being dependent on actual realised returns to investors. The other key safeguard normally incorporated in the investment agreement/LPA is the requirement for investor clearance of conflicts and their management (via an investors or advisory committee). See comments in response to Issue 4.

5. CESR is requested to advise the Commission on the content of the requirements referred to in Article 15(3).

This advice should at least address the following issues:

a) the content of an appropriate, documented and regularly updated due diligence process when investing on behalf of the AIF, according to the investment strategy, the objectives and risk profile of the AIF;

Response

Due diligence is a particular area where the investment executives engaged in investigating and negotiating a venture capital or private equity transaction need to be fully engaged, rather than dependent upon a separate risk management function. Where the firm is large enough each investment decision will typically be subject to a more formal investment committee scrutiny and decision which also serves as a useful check that due diligence normally required by the firm to be done has in fact been done, or if it has not been done, in whole or in part, there are good reasons.

Due diligence is typically performed with the assistance of external professional advisers and tailored to suit each specific investment. We suggest that CESR should not try to second guess and prescribe the exact due diligence to be done into every investment. To do so would be as inappropriate for a professional investor fund as seeking to regulate the content of its investment policy. Moreover, there are some situations where extensive due diligence must be done in any event and others (e.g., when investing in new technologies) where a standard type of full due diligence may not be appropriate to carry out and where the aspects of risk are instead addressed by pricing, risk sharing mechanisms and/or warranties.

In these circumstances, EVCA respectfully suggests that ESMA recommend to the Commission that where an AIF's investment strategy involves a limited number of individually negotiated transactions (as opposed to frequent trading), as in the private equity and venture capital sectors, it will be sufficient if AIFM can demonstrate that their due diligence processes include identification of one or more individuals who will be responsible for coordinating such due diligence and that the due diligence process involve an examination of business issues, financial issues and legal issues relating to the proposed investment, without the need for overly specific, prescriptive procedures, which would be disproportionate for the private equity and venture capital sectors. Appropriate due diligence procedures will vary from case to case, depending very much on the nature and size of investee companies. This requires tailor made assessments from investment professionals, not general procedures.

b) the criteria to be used by competent authorities when assessing whether the risks associated with each investment position of the AIF and their overall effect on the AIF's portfolio can be properly identified, measured, managed and monitored on an ongoing basis, including through the use of stress testing;

Response

Taking into account the types of risks to which AIF may be subject depending on their business model, as discussed above, EVCA respectfully suggests that ESMA advise the Commission that ongoing identification, measurement, management and monitoring of risks

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associated with investments, including through stress tests, is appropriate in the case of AIF with short investment cycles and/or where investors may be subject to risk as a result of short-term fluctuations in asset values, in particular as a result of AIF's use of leverage or remuneration structures that result in payment of compensation based on unrealised gains.

c) appropriate stress testing procedures and their frequency pursuant to Article 15(3)(b);

Response

See comment above. Due to the nature of PE/VC investment stress-testing etc and notably the fact that there is no systemic risk created between the investments of a PE/VC fund which are financed on a stand-alone basis, such mechanisms are not relevant.

d) the criteria to be used in assessing whether the risk profile of the AIF corresponds to the size, portfolio structure and investment strategies and objectives of the AIF as laid down in the AIF rules or instruments of incorporation, prospectus and offering documents.

Response

It is not clear to us what criteria can be used, or need to be used, other than simply checking on whether the AIF does comply with its stated investment policy laid down in the investment agreement negotiated and entered into with its investors, who will also follow this compliance through the extensive and regular reporting typically provided by the PE/VC fund.

VI. ISSUE 6 - ARTICLE 16 LIQUIDITY MANAGEMENT

1. CESR is invited to advise the Commission on the content of rules that are proportionate and necessary for specifying the general obligations placed on AIFM by Article 16(1) and (2).

2. In particular, CESR is invited to advise on:

a) the systems and procedures to be implemented by the AIFM in order to comply with its obligations under Article 16(1), having regard for the appropriateness of these systems and procedures for different types of AIFM and the AIF they manage.

b) the content of the obligation for AIFM to regularly conduct stress tests, under normal and exceptional liquidity conditions, which enable it to assess the liquidity risk of the AIF and monitor the liquidity risk of the AIF accordingly.

c) the circumstances under which the investment strategy, liquidity profile and redemption policy for each AIF managed by an AIFM can be considered to be consistent. In this context, CESR is invited to consider all relevant aspects of the redemption policy, including mechanisms that can be invoked in exceptional circumstances, and assess their consistency with the investment strategy and liquidity profile.

Response:

As discussed below, private equity and venture capital AIF do not normally use leverage at the fund level as part of their investment strategy, but they may incur leverage temporarily as

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a convenience to investors, for example to bridge delays in receipt of required funds from a particular investor or investors.

EVCA respectfully suggests that ESMA advise the Commission that temporary leverage incurred to facilitate an investment, but not as part of an AIF's investment strategy, is not inconsistent with a closed-ended AIF being "unleveraged" for purposes of Article 16. Such borrowings do not increase the size of the fund available for investment nor do they increase the exposure of the AIF.

VII. ISSUE 7 - ARTICLE 17 AND ARTICLE 61 (NEW ARTICLE 50A IN UCITS) INVESTMENT IN SECURITISATION POSITIONS

1. CESR is invited to advise the Commission on the content of rules that are necessary and proportionate for an AIFM to fulfil its obligations under Article 17.

2. In particular, CESR is invited to advise on:

a) the requirements to be met by the originator, the sponsor or the original lender, in order for an AIFM to be allowed to invest in securities as defined in Article 17.

b) the qualitative requirements to be met by an AIFM in order to comply with their obligations under Article 17.

In developing this advice, CESR is invited to take full account of the content of the relevant articles of the Capital Requirements Directive and of measures developed for the same purpose in the context of other legislation, notably Solvency II.

Response

Private equity and venture capital funds do not typically invest in this way. However, companies owned by private equity and venture capital firms do borrow money. Their lenders could be banks or debt funds. We would be concerned about any developments which restrict the ability of EU debt funds to lend to EU private companies.

VIII. ISSUE 8 – SECTION 2 ORGANISATIONAL REQUIREMENTS, ARTICLE 18 GENERAL PRINCIPLES

1. CESR is invited to advise the Commission on the content of rules that are proportionate and necessary for specifying the general obligations placed on an AIFM by Article 18(1).

2. In particular, CESR is requested to advise on the procedures and arrangements to be implemented by the AIFM, having regard to the nature of the AIF managed by the AIFM, in order to comply with its obligations under Article 18(1).

Response

- The Commission notes that the AIFM Directive general principles of organisation are identical to those of the UCITS Directive.

- As noted above in response to Issues 3 and 4, we believe there is some scope to use corresponding provisions in other directives, such as the UCITS Directive as the basis for Level 2 measures under the AIFM Directive. A mere "copy-out" approach would be highly inappropriate, however. This is not least because the UCITS Directive regulates retail funds, whereas the AIFM Directive will govern managers of funds whose investors are

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professionals.

IX. ISSUE 9 - ARTICLE 19 VALUATION

CESR is invited to advise the Commission on:

1. The criteria concerning the procedures for the proper valuation of the assets and the calculation of the net asset value per share or unit to be used by competent authorities in assessing whether an AIFM complies with its obligations under Article 19(1) and Article 19(3).

CESR is invited to consider how these procedures should be differentiated to reflect the diverse characteristics of the assets in which an AIF may invest.

2. The type of specific professional guarantees an external valuer should be required to provide so as to allow the AIFM to fulfil its obligations under Article 19(5).

CESR is asked to consider the impact of the required guarantees on the availability of external valuers to the AIFM industry.

3. The frequency of valuation carried out by open-ended funds that can be considered appropriate to the assets held by the fund and its issuance and redemption frequency.

In particular, CESR is invited to consider how the appropriate frequency of valuation should be assessed for funds investing in different types of assets and with different issuance and redemption frequencies, taking into account different (and varying) degrees of market liquidity. CESR is invited to take account of the fact that such valuations shall in any case be performed at least once a year.

Response

CESR should base its answer on the valuation standards generally recognised by investors and other stakeholders of the various asset classes covered by the AIFMD. In that matter, the private equity and venture capital industry – managers and investors – has developed the International Private Equity and Venture Capital Valuation Guidelines (AKA IPEV Guidelines – downloadable at http://www.privateequityvaluation.com). Investors typically require in the investment management/limited partnership agreements that fund managers follow these Guidelines. Abiding by these Guidelines means that fund managers will fair value the assets of the funds in consistent and accepted manners. CESR should promote the use of standards like the IPEV Guidelines that establish robust methodologies adapted to specific asset classes.

Looking forward, it is important that non-EU AIFM subject to the Directive have sufficient flexibility to comply with local accounting requirements as foreseen by the directive.

X. ISSUE 10 – ARTICLE 20 DELEGATION OF AIFM FUNCTIONS

1. CESR is invited to advise the Commission on the content of rules that are necessary and proportionate to ensure that an AIFM fulfils the conditions under Article 20(1) and Article 20(2).

2. In particular, CESR is invited to advise the Commission on the following, which are applicable both to cases of delegation and sub-delegation:

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a) the criteria that competent authorities should use to assess whether the reasons supplied to justify the entire delegation structure of an AIFM are objective.

b) the circumstances under which a delegate should be considered to have sufficient resources to perform the tasks delegated to it by an AIFM; and to be of sufficiently good repute and sufficiently experienced to perform these tasks.

c) the types of institutions that should be considered to be authorised or registered for the purpose of asset management and subject to supervision. CESR is invited to consider whether to employ general criteria or to specify categories of eligible institution in this context.

d) in the event of a delegation of portfolio or risk management to an undertaking in a third country, how cooperation between the home Member State of the AIFM and the supervisory authority of the undertaking should be ensured.

e) the circumstances under which 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.

3. CESR is invited to advise the Commission on the content of rules that are necessary and proportionate to ensure that an AIFM fulfils the conditions under Article 20(3).

4. In particular, CESR is invited to advise on:

a) the type of evidence necessary for an AIFM to demonstrate that it has consented to a sub-delegation

b) the criteria to be taken into account when considering whether a sub-delegation would result in a material conflict of interest with the AIFM or the investors of the AIFM; and for ensuring that portfolio and risk management functions have been appropriately segregated from any conflicting tasks; and that potential conflicts are properly identified, managed, monitored and disclosed to the investors of the AIF.

c) the form and content the notification under Article 20(3) (b) should take in order to ensure that the supervisory authorities have been properly notified.

5. CESR is also invited to advise the Commission, in relation to Article 20(2), on the conditions under which the AIFM would be considered to have delegated its functions to the extent that it had become a letter-box entity and could no longer be considered to be the manager of the AIF.

Response

- **Objective reasons.** We do not think it would be possible to publish a definitive list of possible objective reasons, but an indicative list may be helpful. There could be a range of reasons for delegating a task, such as:

    - The delegate having staff with investment expertise in relation to particular investments to be made by the AIF. For instance, this expertise might relate to an industry sector (e.g. pharmaceuticals), investment type (e.g. bonds) or geographical location.
    - The delegate having administrative expertise such as legal, accounting or regulatory expertise which is relevant for administrative services.
    - The delegate having marketing expertise and/or potential contacts of use to the AIF and/or AIFM.
    - Cost.

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- Efficiency.
- Delegation to other legal entities within an AIFM's group, where the relevant systems or expertise are housed in that other legal entity.

- Delegation may be objectively justifiable even though the function could be performed by the AIFM, for instance where this saves cost or is more efficient.

- It may be helpful to state reasons which would not be regarded as objective, such as:

  - The appointment of a delegate without regard to their expertise or ability to provide the relevant service.

- **Sufficient resources/reputation.** We note that the AIFM must judge this on appointment of the delegate and on an ongoing basis. We do not consider that this is an area where Commission guidance can usefully supplement the Directive.

- **Undertakings authorised or regulated.** The requirement for prior approval should not have the practical effect of prohibiting AIFM from appointing delegates in jurisdictions where the activities of the delegate may be carried on lawfully without authorisation or regulation. This is a relevant issue because most jurisdictions globally do not authorise or regulate venture capital and private equity AIFM. It is therefore important that competent authorities' ability to consent to such delegation, where appropriate, is not limited in the Level 2 measures. Accordingly, we do not think it would be helpful to specify categories of eligible institution in this context.

- **Qualified and capable of undertaking tasks.** The Commission might refer to the outsourcing requirements in Article 14(2) of the MIFID implementing directive (2006/73/EC).

- **Letter box entity.** Clearly, the mere delegation of AIFM functions (i.e., portfolio management and risk management functions) does not of itself result in the AIFM becoming a letter box entity. We believe that the letter-box-entity concept should be limited to an extreme scenario in which the AIFM and its affiliates no longer perform any management functions, including compliance with the Directive, through their own staff or resources.

- **Co-operation between authorities/prevention of effective supervision.** Please see Part IV Supervision.

- **Sub-delegation.** We consider that our input above is equally relevant in cases of sub-delegation as for cases of delegation.

- **Evidence for demonstrating consent to a sub-delegation.** We consider that this will be a matter for the internal record keeping of the AIFM, and that this need not therefore be further addressed in Level 2.

- **Form and content of notification to competent authorities.** We also consider that this does not need to be addressed in further detail at Level 2. At least, the form of the relevant notification should be left to Member State competent authorities. If content requirements are to be addressed in Level 2 measures, the requirements should be high level rather than prescriptive and exhaustive. This will ensure that Member States have flexibility to request the information, and level of detail, that is appropriate and will avoid unnecessarily burdening national competent authorities.

- **Conflicts of interest.** This is another area in which Level 2 measures might reasonably be based on existing EU law, such as MiFID and that UCITS Directive, subject to the comments above on conflicts of interest arising in different AIF business models. It is vital, however, that any read-across takes account both of the professional investor base of funds managed/marketed by PE/VC AIFM subject to the Directive as well as of the

contractual relationship between these investors and the AIFM. As far as functional and hierarchical separation of functions is concerned, any Level 2 measures should be outcomes-focused and not unduly prescriptive. This will avoid the imposition of disproportionate requirements on smaller delegates, or the imposition of requirements with which compliance is practically impossible.

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PART II: DEPOSITARY (ARTICLE 21)

I. ISSUE 11 – CONTRACT EVIDENCING APPOINTMENT OF THE DEPOSITARY

1. CESR is requested to advise the Commission on the necessary particulars to be found in the standard agreement evidencing the appointment of the depositary. In its advice, CESR should take into account the consistency with the respective requirements in the UCITS Directive.

2. CESR is encouraged to provide the Commission, if possible, with a draft model agreement.

Response

As a general rule regarding depositary, full account should be taken of the tailoring that the legislator has foreseen regarding depositaries in the case of closed-ended funds with no redemption rights.

Considerable caution should be exercised before assuming that contractual terms and other depositary provisions which may be appropriate for the publicly traded securities and related derivatives covered by the UCITS Directive are appropriate for translation to private equity and venture capital assets.

It seems to us unlikely to be helpful, or even practical, to produce a model depositary agreement which would fit all the different fund types and asset classes covered by the AIFMD. For example the depositary services needed by a private equity or venture capital AIF involved in the processing of a one-off complicated private company structuring, which may be negotiated among many parties over many hours or days and completed outside normal banking hours, are quite different from the services needed by a mutual fund or hedge fund which is trading and voting or otherwise participating in listed company corporate actions which have a more routine timetable for action.

However, a list of matters which can sensibly be covered in such agreements may be worthwhile and could include:

- Identifying the types of asset covered and whether they do or may include any assets which are subject to the special custody obligations and liabilities of Article 21 (7)(a), which as noted below should mean securities (not contractual investments such as partnership interests nor, generally, derivatives) which:
    - are dematerialised in a way which means that they can only effectively be held in a securities account, and not, for instance, simply dematerialised in the sense that ownership is recorded on the register kept by the company or its registrar; and
    - are liquid traded securities which are fully fungible, with no special obligations attaching to the holder and no restrictions on transfer which could make the identification of the underlying owner of assets held in a securities/financial instruments account relevant.
- Requiring segregation of assets of the AIF from those of the AIFM or the depositary as such but allowing flexibility relevant to the type of AIFM and assets held (quantity and uniqueness) as to how this is achieved (and if appropriate giving circumstances where this will not be possible, for instance when held in some types of securities clearing and settlement account)
- Minimum information required by the depositary from each respective type of AIFM in order to enable it to perform its duties under the Directive

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- Minimum information and service levels required by the AIFM from each respective type of depositary
- Setting out or referring to the duties and responsibilities of the depositary as provided for under the Directive
- Setting out the permitted powers of delegation of custody and the ability of the depositary to obtain assistance in carrying out functions which it does not or cannot delegate

II. ISSUE 12 - GENERAL CRITERIA FOR ASSESSING EQUIVALENCE OF THE EFFECTIVE PRUDENTIAL REGULATION AND SUPERVISION OF THIRD COUNTRIES

1. CESR is requested to advise the Commission on the criteria for assessing whether the prudential regulation and supervision applicable to a depositary established in a third country with respect to its depositary duties are to the same effect as the provisions laid down in European law.

In this regard, CESR is invited to take into account at least whether the depositary:

- is subject to specific capital requirements for the safe-keeping of assets.
- is subject to supervision on an ongoing basis.
- provides sufficient financial and professional guarantees to be able to effectively pursue its business as a depositary and meet the commitments inherent to that function.
- is subject to rules as stringent as those laid down in Article 21 AIFMD

2. CESR is requested to advise the Commission specifying the criteria for assessing that prudential regulation and supervision of a third country applicable to the AIF depositary with respect to its depositary duties established in a third country is to be considered as effectively enforced. Inter alia, CESR should take into account whether the depositary is subject to the oversight of a public authority, meaning that, at least:

- the authority has the power to request information from the depositary
- the authority has the power to intervene with respect to, and sanction, the depositary.

Response

Article 21(5)(b)(ii) requires that a third-country depositary be subject to “effective prudential regulation (including minimum capital requirements) and supervision which are to the same effect as the provisions laid down in European Union law and which are effectively enforced”. Article 21(3) also provides that, without prejudice to Article 21(5)(b), the depositary may be a credit institution or any other entity of the same nature as the entities listed in Article 21(3)(a) and (b): i.e., credit institutions and certain investment firms subject to the CRD, “including capital requirement for operational risks".

EVCA respectfully submits that CESR should take into account the variety of institutions that may perform depositary functions in different jurisdictions and the variety of regulatory systems that apply to those institutions. EVCA also notes that the requirements imposed on depositaries in the Directive are novel, and unique. It would be unreasonable and unrealistic to expect that any other regulatory system would impose the same set of requirements as the Directive. Accordingly, EVCA submits that the Commission should take a flexible approach to determining whether third-country rules are “to the same effect” as those in European law. In this regard, EVCA notes that in asking CESR to advise on the determination whether third-country rules are “as stringent” as the Directive, the Commission uses the incorrect standard; the standard set out in the Level 1 Directive is “to the same effect”, not “as stringent”.

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Specifically, EVCA respectfully suggests that CESR recommend that third-country entities that are subject to supervision and to capital requirements covering their regulated activities should qualify under Article 21(5)(b) even if local law does not impose separate capital requirements applicable only to depositary activities. Similarly, where a third-country institution is subject to liability to its clients, by statute or by contract, statutory rules imposing strict liability as under the Directive should not be required for a finding that a third-country entity is subject to regulation "to the same effect" as the Directive.

We would encourage CESR to conclude that where the criteria for assessing that prudential regulation and supervision are "effectively enforced", that the depositary is also "subject to supervision on an ongoing basis". The power of a regulator to request information, intervene and sanction a depositary indicates that the depositary is subject both to supervision on an ongoing basis, and to effective enforcement.

III. ISSUE 13 – DEPOSITARY FUNCTIONS

<u>Depositary functions pursuant to paragraph 6</u>

1. CESR is requested to advise the Commission on the conditions for performing the depositary functions pursuant to Article 21(6). CESR is requested to specify conditions for the depositary to ensure that:

- the AIF's cash flows are properly monitored;
- all payments made by or on behalf of investors upon the subscription of shares or units of - an AIF have been received and booked in one or more 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 acting on behalf of the AIF at an entity referred to in Article 18 (1) (a) to (c) of Commission Directive 2006/73/EC in accordance with the principles set forth in Article 16 of Commission Directive 2006/73/EC.
- where cash accounts are opened in the name of the depositary acting on behalf of the AIF, none of the depositary's own cash is kept in the same accounts.

In its advice, CESR should take into account the legal structure of the AIF and in particular whether the AIF is of the closed-ended or open-ended type.

<u>Response</u>

The normally closed ended nature of a private equity or venture capital AIF might be thought to make the booking of payments made by investors relatively straightforward. This is not necessarily the case, because of the nature of commitments to e.g. limited partnerships under which funds required are drawn down as and when needed to make investments and almost immediately paid on to the vendor of the investments - sometimes by way of payment into solicitors' accounts to be released on completion of the transaction.

It would be desirable to make it clear that monitoring of cash flows by the depositary is not intended to insert an additional account with the depositary through which all funds must flow, nor to require it to sign off on every cash movement. Each of these could introduce significant delay into the flow of funds into investments when draw downs are made and should not be necessary for the depositary to be able to monitor cash flows, which could be done by receiving reports or auditing statements.

We believe that significant clarification is needed of the relevant provisions in the Level 1 Directive to address the question whether these provisions actually <u>prevent</u> a depositary which is a bank being one of the entities at which cash accounts are held and/or change the normal debtor/creditor relationship involved in banking relationships. Where the depositary is a bank the normal legal position, as we understand it, is that funds held with it are merely debts owed by it to its depositor. MiFID recognises this by expressly providing that the client

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money obligations under Article 18(1) of Commission Directive 2006/73/EC do not apply to a credit institution receiving client funds when providing MiFID services, but there does not seem to be an equivalent provision in the AIFMD.

2. CESR is requested to advise the Commission on the conditions applicable in order to assess whether:

- an entity can be considered to be of the same nature as the entity referred to in Article 18 (1) (a) to (c) of Commission Directive 2006/73/EC, in the relevant non-EU market where opening cash accounts on behalf of the AIF are required;
- such an entity is subject to effective prudential regulation and supervision to the same effect as the provisions laid down in European Union law and which is effectively enforced.

Response

The entities referred to in Article 18 (1) (a) to (c) of Commission Directive 2006/73/EC include central banks wherever located and also any bank authorised in a third country. It is therefore our understanding that these conditions would only be required in order to identify any other types of third-country credit institution suitable to be used for this purpose.

3. CESR is requested to advise the Commission on the conditions applicable in order to determine what shall be considered as the relevant market where cash accounts are required.

Response

Increasingly, some private equity and venture capital funds act as development capital providers and may invest in third world or developing countries. We do not believe it should be necessary, or is desirable, to have an account in each country in which an investment is made. However, it will be necessary to have a means of payment for assets acquired and receipt of any proceeds.

As with private equity investments in the developed world it is not uncommon to pay completion monies for a transaction to the lawyers acting on the relevant transaction, to be held in their client account for release once the legal documentation is completed and approved. This appears to us to be one possible sensible and prudent means of providing a means of payment without there being a need for a cash account for each jurisdiction in which a transaction is done.

Depositary functions pursuant to paragraph 7

1. CESR is requested to advise the Commission on:

- the type of financial instruments that shall be included in the scope of the depositary's custody duties as referred to in point (a) of Article 21(7), namely (i) the financial instruments that can be registered in a financial instruments account opened in the name of the AIF in the depositary's books, and (ii) the financial instruments that can be "physically" delivered to the depositary;
- the conditions applicable to the depositary when exercising its safekeeping custody duties for such financial instruments, taking into account the specificities of the various types of financial instruments and where applicable their registration with a central depositary, including but not limited to:
  - **the conditions upon which such financial instruments shall be registered in a financial instruments accounts opened in the depositary's books opened in the name of the AIF or, as the case may be, the AIFM acting on behalf of the AIF;**

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- **the conditions upon which such financial instruments shall be deemed (i) to be appropriately segregated in accordance with the principles set forth in Article 16 of Commission Directive 2006/73/EC9), and (ii) to be clearly identified at all times as belonging to the AIF, in accordance with the applicable law; and what shall be considered as the applicable law.**

Response

The question of which financial instruments (i) can be registered in a financial instruments account opened in the name of the AIF in the depositary's books and (ii) can be "physically" delivered to the depositary is of critical importance to private equity and venture capital funds and fund managers and clear guidance is needed as soon as possible if they are to be in any position to negotiate and put in place depositary arrangements in accordance with the AIFMD. It is a good example of circumstances where considerations applying to PE and VC funds are completely different from those applying to UCITS funds. UCITS funds will, apart from any derivatives, be almost entirely invested in liquid listed securities which are highly fungible and immediately transferrable without involving any liabilities for the holder.

Answering the question correctly for the relevant asset class is crucial both for the liabilities undertaken by depositaries which act in relation to private equity assets and for the types of depositary which may be used (since one of the tests for the wider range of depositary is an absence of paragraph 7(a) investments which must be held in custody).

We note that MiFID defines financial instruments very broadly and includes within that term:

- transferable securities negotiable on the capital markets including shares, similar securities in companies partnerships and other entities, depositary receipts, bonds and securitised debt, other securities giving the right to acquire or sell such securities or to a cash settlement by reference to them or certain other factors;
- money market instruments;
- interests in collective investment undertakings, whether or not transferable; and
- an extensive range of different types of derivative, both OTC and exchange traded.

Moreover there are very significant differences in interpretation between Member States as to what constitutes a transferable security subject to MiFID. For example in Germany and Sweden interests in partnerships and private companies are not regarded as transferable securities subject to MiFID whereas in many other Member States they would be regarded as financial instruments subject to MiFID even when they are subject to some restrictions on transfer, as is commonly the case for private company shares, partnership interests and contractual investments. This lack of consistency in interpretation should not be allowed to bring legal uncertainty to the identification of instruments covered by paragraph 7(a).

The term "financial instruments account…… in the depositary's books" is also potentially unclear. We understand that the intention was to exempt as far as possible private equity and venture capital from the custodian part of the depositary provisions. At one level it is "possible" for any asset to be recorded in books kept by a depositary but clearly that is not what is meant in Article 21(7)(a) because Article 21(7)(b) refers to the maintenance of records of assets. At another level it is "possible", at least in those legal systems which recognise a law of trusts and the possibility of a separation of legal and beneficial ownership, for almost any financial instrument, indeed almost any asset of any kind, to be held in an account by a depositary in the sense that the depositary or a nominee under its control, becomes the legal owner of the investment, whatever it may be, and an account or record is kept of the fact that beneficial ownership is that of the AIF. Again we do not believe this was the intention of paragraph 7(a), particularly bearing in mind that Article 21(15)(c) expressly indicates that financial instruments issued in a nominative form and registered with an issuer or registrar will be subject to paragraph 7(b).

We note that consideration is being given to the production of a Securities Law Directive which is intended to address "securities accounts" and govern the responsibilities of account

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providers and account holders in certain situations where there is intermediated holding of financial instruments. Consultation papers relating to that Directive have identified the many legal complexities and differences of law and legal systems in addressing such arrangements and these complexities should not be underestimated in any Level 2 measures under the AIFMD.

Moreover we respectfully suggest that considerable caution should be exercised in assuming that any provisions or definitions in any Securities Law Directive (as and when finalised) will be capable of simple application or read across in the AIFMD. As we understand the Securities Law Directive will be a Directive which applies when as a matter of fact securities are held in a securities account and therefore need to have the responsibilities of account providers to account holders (recognising that there may be a whole chain of such providers and holders) delineated, It will not be a Directive which requires any securities to be held in such an account, nor one which addresses legal ownership to the securities. We anticipate that the Securities Law Directive may therefore define very broadly the instruments which may, on a non-mandatory basis, be held in a securities account,

We respectfully suggest that because Article 21(7)(a) is effectively mandatory in nature by saying that the depositary must hold in custody financial instruments which can be held in a financial instruments account Level 2 provisions should make it clear that the relevant financial instruments are limited to securities (not contractual investments such as partnership interests nor, generally, derivatives) which:

- are dematerialised in a way which means that they can only effectively be held in a securities account, and not, for instance, simply dematerialised in the sense that ownership is recorded on the register kept by the company or its registrar; and
- are liquid traded securities which are fully fungible, with no special obligations attaching to the holder and no restrictions on transfer which could make the identification of the underlying owner of assets held in a securities/financial instruments account relevant.

It appears to us that any other interpretation would:

- force intermediation, with all its associated risks for the AIF and its investors, on a whole range of financial instruments which need not be held in this way.

- also force depositaries to hold financial instruments to which ongoing liabilities and obligations are attached under their terms or by virtue of transactions in the relevant instruments (e.g. to contribute to a partnership or to give warranties and indemnities in transactions relating to private company shares or debt securities) thus increasing their liabilities and responsibilities inappropriately.

As previously noted, it appears to us that this interpretation is supported by the terms of paragraph 15(c) relating to the acts of the Commission for which advice is sought from CESR. The third indent of paragraph 15(c) expressly states that financial instruments issued in a nominative form and registered with an issuer or depositary should be subject to paragraph 7(b), not 7(a). In our view that is correct and the same should apply to all investments made by a PE/VC fund (apart from any investments made in a publicly listed and traded security).

Similarly share certificates or the contractual agreements relating to partnerships and derivatives may be physically delivered to the depositary, but none of these actually amount to the physical delivery of a financial instrument to the depositary. At most they are some evidence of title. Real physical delivery would be possible (though inconvenient) with other types of asset, such as precious metals or commodities, but paragraph 7(a) is only concerned with financial instruments.

We suggest that the only financial instruments which can actually be physically delivered are those bearer investments where title is held by whoever holds the relevant certificate of title. We can see that it may be appropriate to require such investments to be held by the depositary but do not think the physical delivery class of investments should be read more widely.

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2. CESR is requested to advise the Commission on:

- the type of "other assets" with respect to which the depositary shall exercise its safekeeping duties pursuant to paragraph 7(b), namely all assets that cannot or are not to be kept in custody by the depositary pursuant paragraph to Article 7(a);
- the conditions applicable to the depositary when exercising its safekeeping duties over such "other assets", taking into account the specificities of the various types of asset, including but not limited to financial instruments issued in a 'nominative' form, financial instruments registered with an issuer or a registrar, other financial instruments and other types of assets.

Response

As noted above, we believe that the category of 7(a) investments should be restricted to those fully liquid and fungible public traded securities which do not carry, nor require the holder to enter into related agreements which carry, any additional liabilities or responsibilities.

3. To that end, CESR is requested to advise the Commission on:

- the conditions upon which the depositary shall verify the ownership of the AIF or the AIFM on behalf of the AIF of such assets;
- the information, documents and evidence upon which a depositary may rely in order to be satisfied that the AIF or the AIFM on behalf of the AIF holds the ownership of such assets, and the means by which such information shall be made available to the depository;
- the conditions upon which the depositary shall maintain a record of these assets, including but not limited to the type of information to be recorded according to the various specificities of these assets; and the conditions upon which such records shall be kept updated.

Response

As far as private equity and venture capital investments are concerned, acquisitions and disposals are usually substantial M&A transactions requiring a great deal of legal input or other due diligence. We believe that a depositary could frequently exercise its paragraph 7(b) safekeeping responsibilities, i.e. its responsibilities to verify ownership and keep related records, by receiving copies or evidence of entries on share registers. In some circumstances, depending on the jurisdiction concerned and nature of the investment it may need copies of some additional material or legal opinions. It should only be in rare situations that the depositary needs to undertake independent work beyond checking that an appropriate procedure has been followed.

The information to be recorded would normally simply be the number and nature of securities or other investments acquired and on behalf of which AIF(s). The record would need to be updated on sale and also on any capital restructuring by the portfolio company involving a change in either the number/kind of investments covered.

It should also be noted that additional independent verification of holdings is already today undertaken by the PE/VC funds' auditors in connection with the annual valuation process and the reporting of the audited annual accounts.

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4. In its advice, CESR should also consider the circumstances where assets belonging to the AIF, are subject to temporary lending or repurchase arrangements or any type of arrangements under which financial instruments may be re-used or provided as collateral by the AIF or AIFM on behalf of the AIF, whether or not such arrangements involve transfer of legal title to the financial instruments, and advise on the conditions applicable to the depositary to perform its safekeeping duties accordingly.

Response

It is rare for private equity and venture capital AIF to engage in stock lending or repo or collateral arrangements. However, it may happen if the AIF for some reason includes Treasuries or liquid stocks (perhaps because it is not a self liquidating fund which draws down and pays out on an as-needed basis, but instead has funds paid down at the outset which it decides to invest in highly liquid instruments ready for draw down), or on an IPO the private equity and venture capital owner may make securities available on a loan basis to those responsible for stabilising the issue.

Depositary functions pursuant to paragraph 8

1. CESR is requested to advise the Commission on the conditions the depositary must comply with in order to fulfil its duties pursuant to Article 21(8). The advice shall include all necessary elements specifying the depositary control duties when inter alia verifying the compliance of instructions of the AIFM with the applicable national law or the AIF rules or instruments of incorporation, or when ensuring that the value of the shares or units of the AIF is calculated in accordance with the applicable national law and the AIF rules or instruments of incorporation and procedures laid down in Article 19.

Response

We suggest that the duties of the depositary should not require it to conduct extensive independent investigations into every aspect of potentially relevant law but should essentially be confined to:

- receiving copies of audit checks on valuation procedures (see above comments on Article 19); and
- where the depositary has substantial and reasonable grounds for believing that instructions the AIFM is giving are contrary to law or the AIF constitution, requiring the AIFM to produce reasonable evidence of compliance, or legal or accounting advice in relation thereto.

IV. ISSUE 14 – DUE DILIGENCE

1. CESR is requested to advise the Commission on the duties the depositary has to carry out in exercising its due diligence duties pursuant to Article 21(10), namely:

- procedures for the selection and the appointment of any third party to whom it wants to delegate parts of its tasks; and
- procedures for the periodic review and ongoing monitoring of that third party and of the arrangements of that third party in respect of the matters delegated to it.

2. CESR is encouraged to develop a comprehensive template of evaluation, selection, review and monitoring criteria to be considered by the depositary while exercising its due diligence duties under Article 21(10).

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Response

a. For the reasons given above we believe that private equity or venture capital investments would typically not include financial instruments subject to Article 21(7)(a). In addition, as previously noted most private company holdings, even those where certificates of title are issued, have the primary evidence of title in the register kept by the company or its registrar. If a share certificate is lost a new one can be issued readily since the owner is known to the company and can give any necessary indemnities. It is in many jurisdictions further not generally possible to deal in the securities without the consent and involvement of the investee company and its board of directors or other governing body. In other cases the Shareholder Agreement or Articles of Association may stipulate a first right of refusal or other consent mechanism. Accordingly the risk of "loss" is negligible. The assets concerned are, from a custody point of view, relatively simple in nature and the systems, structures and expertise required to hold them in custody and record their ownership can be likewise relatively simple.

b. In view of this, and of the illiquid nature of private equity and venture capital investments and the relatively remote risk of loss, we suggest that key elements in the appointment of a third party delegate should include:

1 Initial due diligence on the record keeping and competence of the delegate and its systems for ensuring segregation of assets
2 Ensuring that the sub-custodian is subject either by contract or otherwise to the segregation, use and other general obligations and prohibitions and prohibitions referred to in Article 21(10)(d).
3 Annual reporting by the delegate and where appropriate updating of due diligence.

V. ISSUE 15 – THE SEGREGATION OBLIGATION

1. CESR is requested to advise the Commission on criteria to be satisfied to comply with the segregation obligation whereby the depositary shall ensure on an ongoing basis that the third party fulfils the conditions referred to in Article 21(10)(d)(iv).

Response

As previously noted in many cases it is entirely possible for private equity and venture capital investments to be segregated by registration in the name of the AIF concerned or in the name of a nominee which only holds client assets, and not assets of the depositary.

Where additional intermediation is involved and/or there is intermingling of the assets of different clients in a single name or account clear records should be kept and regularly reconciled of the clients entitled to those assets.

VI. ISSUE 16 – LOSS OF FINANCIAL INSTRUMENTS

1. CESR is requested to advise the Commission on the conditions and circumstances under which financial instruments held in custody pursuant paragraph 7(a) shall be considered as "lost" according to Article 21(11). In its advice, CESR should take into account the various legal rights attached to the financial instruments depending, for example, on the legal concepts ('ius ad rem' vs. 'ius in personam') used in the jurisdiction where they have been issued and any legal restrictions applicable to the place where they are kept in (sub-)custody.

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2. In its advice, CESR should specify circumstances when such financial instrument should be considered permanently "lost", to be distinguished from circumstances when such financial instruments should be considered temporarily "unavailable" (held up or frozen).

To that end, CESR shall consider inter alia the following circumstances:

- Insolvency of, and other administrative proceedings against, a sub-custodian;
- Legal or political changes in the country where financial instruments are held in sub-custody;
- Actions of authorities imposing restrictions on securities markets;
- Risks involved through the use of settlement systems; and
- Any other circumstances which may prevent the AIF from using or disposing of its assets that are kept in custody by a depositary or a sub custodian.

Response

As noted above, we believe that paragraph 7(a) should not apply to most private equity and venture capital investments. Many of the circumstances identified as possible grounds for "loss" arise out of public trading and settlement and the actual use of a custodian/depositary (and sometimes subcustodian) in trading situations, which is not generally the case for private equity and venture capital.

"Lost" could mean that such instruments are

(i) no longer held for the account of the AIF;
(ii) no longer held by the AIF;
(iii) no longer held by the custodian.

The loss of 'ius in personam' by the AIF should certainly qualify as "loss". Where the depositary is holding the instruments as trustee, "loss" means the loss of the 'ius in rem' by the depositary and/or the loss of the 'ius in personam' by the depositary and/or the AIF.

Insolvency of the custodian should not lead to loss if the segregation of assets is respected. See above. However in pooled securities accounts where assets are used to settle transactions of many underlying holders and then there is a settlement problem or intervening insolvency it is possible that there will be loss by some holders.

Loss of value of the investments concerned, insolvency of the investee company, restructuring of a company or investments such that certain investments are cancelled in exchange for others or change their nature should not be regarded as "loss" of the original investment.

Expropriation of investments or their cancellation by law without any recompense probably does amount to loss, though not one which can be fully guarded against.

VII. ISSUE 17 - EXTERNAL EVENTS BEYOND REASONABLE CONTROL

1. CESR is requested to advise the Commission on conditions and circumstances for events to be considered as:

- external,
- going beyond reasonable control, and
- having consequences which would have been unavoidable despite all reasonable efforts to the contrary.

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2. If possible, CESR is requested to advise the Commission on a non-exhaustive list of events where the loss of assets can be considered to be a result of an external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary. CESR is encouraged to consider the appropriate form (e.g. guidelines) of such a list.

Response

As noted above, we do not believe these provisions should apply to private equity and venture capital so at this stage will not comment in detail.

If they did, then examples of situations which we think would be the result of external events beyond reasonable control would include political action or expropriation and the insolvency or default of clearing or settlements systems.

VIII. ISSUE 18 – OBJECTIVE REASON TO CONTRACT A DISCHARGE

1. CESR is requested to advise the Commission on the conditions and circumstances under which there is an objective reason for the depositary to contract a discharge pursuant to Article 21(12).

2. In its advice, CESR is encouraged to provide an indicative list of scenarios that are to be considered as being objective reasons for the contractual discharge referred to in Article 21(12).

Response

We believe that in most situations where there is a good practical reason for delegating safekeeping functions (e.g. location, jurisdiction, specialist asset class, expertise of the delegate) that objective reason for delegation should also be regarded as an objective reason for contractual discharge.

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PART III

TRANSPARENCY REQUIREMENTS AND LEVERAGE

I. ISSUE 19 - ARTICLE 4 DEFINITION OF LEVERAGE

1. CESR is requested to provide the Commission with a description of relevant methods by which AIFM increase the exposure of AIF whether through borrowing of cash or securities, or leverage embedded in derivative positions or by any other means, including any financial and/or legal structures involving third parties controlled by the AIF. This description or mapping should distinguish between the various business models and approaches to leverage in the AIFM industry. In its advice, CESR should take into account the guidance provided in recital 14.

2. CESR is requested to advise the Commission on the appropriate method or methods for the calculation of leverage for the purpose of this Directive. The analysis should, inter alia, take into account the appropriateness, accuracy, cost, comparability and practicability of the different methods.

Response

As a general principle, private equity and venture capital funds do not use leverage at fund level to increase the exposure of the fund, and a fund's constitution will typically prohibit that.

However, in order to ensure that other "borrowing" arrangements are not inadvertently within the definition of "leverage", it is important that CESR's advice to the Commission takes proper account of the typical structure and business model of a venture capital or private equity fund, especially those which are structured as UK limited partnerships (LPs), which is a very common structure for many European private funds (including many which are not located in the UK), or Luxembourg SICARs. The business model and legal structure for these funds is very different to that employed by many hedge funds and other forms of private fund and these must be fully respected in the definition.

The first point to note is that, for legal reasons, many funds structure their commitments from investors as "loans". This is necessary in order to avoid legal restrictions on returns of capital, which are not consistent with a fund's business model (i.e. funds are limited life and self-liquidating).

It is therefore important that the final definition of leverage does not include loans to the fund made by investors in the fund as part of their commitment to the fund. These do not increase the size of the fund or the fund's exposure, even though, in a legal, technical sense, they do constitute "borrowing".

Secondly, although most fund documents (as a result of negotiations with investors) include restrictions on the use of leverage at fund level, it should also be noted that many unleveraged funds do use bank facilities as part of their cash flow management. In particular, funds will typically "bridge" funding calls ("draw downs") from investors by taking out short term borrowings with a bank, so that investments can be completed quickly and numerous small draw downs are not needed. Not only is this administratively convenient for the funds, but it is often an investor requirement (to avoid very frequent cash calls on short notice), and it also facilitates emergency or "rescue" financings when fast action is needed to fund a portfolio company with short term liquidity issues. Again, these borrowings (which are usually secured against investor commitments and are only intended to provide short term finance) do not increase the exposure of the AIF to its underlying investments - that is neither the intention nor the effect of the arrangements. It is important that the definition of leverage does not inadvertently cover funds which make use of these types of banking facilities.

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Finally, it is clear from the Directive (Recital 14 and Article 4 (w)) that it is not the intention of the legislator to include within the definition of leverage, borrowing which is embodied in the entities which are invested in by a private equity fund. It is clear that such borrowings do not increase the exposure of the AIF as the fund is not itself responsible for it. Such clarity should in no way be affected by the definitions to be adopted as delegated acts.

II. ISSUE 20 - ARTICLE 22 ANNUAL REPORT

1. CESR is requested to advise the Commission on the content and format of the annual report. In its advice, CESR should consider whether all or any of the information referred to in Article 23 should be included in the annual report and the need for appropriate explanatory notes.

2. CESR is requested to advise the Commission on the content and the format of a balance sheet or a statement of assets and liabilities. In its advice, CESR should specify in particular:

- the appropriate presentation, elements and level of detail of the AIF's assets;
- the appropriate presentation, elements and level of detail of the AIF's liabilities;
- the appropriate presentation, the elements and level of detail of net assets (shareholders' or unitholders' equity); and
- the statement of cash inflows to and outflows from the AIF.

3. CESR is requested to advise the Commission on the content and format of an income and expenditure account for the financial year. In its advice, CESR should specify in particular the elements and the level of detail of AIF's income and expenditure accounts.

4. CESR is requested to advise the Commission on the content and format of the report on the activities of the financial year. In its advice, CESR should consider specifying inter alia:

- statement explaining how the fund has invested its assets during the relevant period in accordance with its published investment policy;
- overview of the AIF's portfolio and, where appropriate, the AIF's major investments;
- financial results; and
- directors' and corporate governance report depending on the legal structure of the AIF.

5. CESR is requested to advise the Commission on how material changes in the information listed in Article 23 during the financial year covered by the report should be best presented in the annual report.

6. CESR is requested to advise the Commission on the content and the format of the remuneration disclosure required under points (e) and (f) of Article 22(2) including the details on the form of remuneration.

<u>**Response**</u>

1. <u>Content and format of the annual report</u>

- The provision of fund accounts to competent authorities is a significant change from current practice, where the fund accounts are often provided only to the investors. It will therefore be important to ensure that commercially sensitive and confidential information is not disseminated in a way which would have a detrimental impact on the performance of the fund, and therefore prejudice its investors.

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- Currently investors will be provided with information on the valuation of the investments held by a fund as well as detailed information on the performance of those investments and the forecasted performance of those investments in future periods. Often this information is considerably above that required to be presented in the statutory accounts of the underlying investments (where these are also prepared). It is disclosed on a confidential basis.

- The valuation of investments is not intended to reflect the amount at which it is expected that they will be ultimately realised. However, this is clearly an interpretation that could be made by others seeking a future involvement in that investment, and disclosure of that information could harm the fund's interests.

- We believe that it is inappropriate to provide the competent authority with the same level of detail that is presented to investors, particularly where that information is likely to or could become available to the public or to competitors.

- We therefore consider that, since Level 1 requires that accounts be made available to the competent authority, there should be clear guidance within Level 2 regarding what the authority will use that information for and whom it shall be provided to. Furthermore, we would suggest that the content of the filing to the competent authority be abbreviated to avoid any prejudicial information being disclosed. This could be facilitated through only presenting aggregated information on valuation of investments, and also by altering the disclosure depending on the nature of the fund (e.g., listed closed ended fund will require greater disclosure than non listed closed ended fund).

- Should disclosure be required on an investment-by-investment basis, then this should be of the initial cost of investment only, with the aggregate valuation as at the reporting date presented as a note.

- Dependent on the purpose of making available fund accounts to the competent authorities, we do not consider that the structure, content and format of the fund accounts should require disclosures over and above those that are requested by the investors.

- The Directive requires that the fund’s accounts should be prepared in accordance with accounting standards of the home Member State of the AIF (or, as the case may be, in accordance with the accounting standards of the third country where the AIF has its registered office) <u>and</u> with the accounting rules laid down in the fund rules. This begs a question as to the requirement where these two standards are inconsistent, as is often the case because investors have particular reporting requirements which are not exactly the same as those mandated by a particular set of accounting standards. Perhaps the most important example of such an inconsistency is the requirement to prepare consolidated accounts. Under the GAAP of some Member States, a fund which controls underlying portfolio companies may be required to fully consolidate those companies in its own financial statements. This is an extremely expensive and often impossible requirement for an investment fund, as acknowledged by US GAAP, which includes an express exclusion from the consolidation requirement for "investment entities". It also produces accounts which are meaningless to investors and so they typically require the fund's accounts to show investments at fair value or (for certain types of fund) adjusted cost.

- On the basis of the above arguments and in line with the overarching objective of maximum harmonisation, the need for differentiation and the principle of proportionality as per Chapter I.2. of the Request, <u>we believe that the Commission can positively contribute to the transparency and relevance of annual reports of private equity and venture capital funds by recognising an explicit exemption from any consolidation requirements</u>. Implementing measures could foresee that any AIF is de

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facto exempt from consolidation irrespective of the applicable GAAP rules. There is abundant literature of the benefits of fair value accounting for private equity and venture capital funds as well as the irrelevance of consolidated financial statements for such funds so we will not develop this topic further in this paper.

- There are also other examples of accounting standards which investors require to be modified by the fund in preparing its accounts. We believe that it would be very expensive and unnecessary to require two sets of accounts to be prepared - one in compliance with local GAAP and one in compliance with the fund rules, and we do not think that this is the intended effect of Article 22. In our view the delegated acts should make it clear that, where the investors in the fund rules require certain modifications to be made to local GAAP in order to meet their needs as the main users of those financial statements, reports which comply with those rules are sufficient to meet the requirement of Article 22.

- In response to the reference to Article 23, we do not see a need to include the information specified in that Article in the annual report, and we do not believe that it would be practical to do so. The information required to be disclosed to investors at the time they invest will likely be historic by the time the fund prepares its first (or next) annual report. It will be misleading to include this, and seems unnecessary because the Article 23 disclosures are intended to provide investors the information which they need to determine whether to invest or not, and there is therefore little point in giving them the information again after they have invested. The annual report already has to include any material changes to the Article 23 disclosures (as per Article 22 (2)(d)), which will ensure that investors have notice of any changes that could affect them. It should therefore be made clear that the information referred to in Article 23 does not need to be included in the first annual report and that only the changes shall be reported in subsequent reports. The reference point for assessing changes in the future shall however be clearly set as “the information to be disclosed to investors at the time they invest as per Article 23”.

- There is no additional value to the investors nor any other potential users of the fund accounts to see the information required from Article 23 on a year by year basis.

2. Balance Sheet

- The Directive encompasses a very large range of funds that vary significantly by nature and type of investments, including hedge funds, real estate funds, private equity and venture capital funds. Even within the private equity and venture capital fund industry itself, investors distinguish between a significant diversity of funds such as buyout, venture capital, mezzanine and fund of funds. The format of the balance sheet and income statement for such funds varies according to the nature of the fund, the legal form and of course according to the applicable GAAP. We do not believe that it is practical or desirable to define a rigid format or content of the financial statements through the implementing measures. In many jurisdictions, such format and content is already well defined either through the applicable GAAP and/or through specific legislation applicable at the level of the fund vehicle.

- If the Commission wants to define a “minimum standard” for funds that do not fully apply existing GAAP but mainly rely on accounting rules laid down in the fund rules, we believe that it would be sufficient to specify in the implementing measures that the annual accounts must include a statement of investments that contains enough information for the investor to make an informed judgement of the development of the activities of the AIF.

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3. Income and expenditure account

Refer to our comments in point 2.

4. Report on activities

The content of the report on the activities of the financial year is already defined in most European legal and accounting frameworks. We understand that the elements to be included in the report on the activities of the financial year of AIF as defined by the implementing measures would come on top of the existing requirements. We believe that such additional disclosures should be limited to (i) a short description of the new investments made during the year, either by investment or by category of investments and the confirmation that such investments comply with the AIF's investment policy, (ii) a table presenting the AIF's portfolio with a few short comments on the development of the activities of the most significant investments, (iii) a short description of the most significant exits / sales during the period, and (iv) a short description of the fund's financial performance using existing recognized fund performance measures. However, it is vital that the fund is not obliged to disclose information that it has received in circumstances of confidentiality, and which it is not permitted to disclose. An explicit recognition of that is important.

5. Material changes

Refer to our comments in point 1.

6. Remuneration

- We believe that the description "senior management and members of staff of the AIFM whose actions have a material impact on the risk profile of the AIF" is intended to be a single category, and that therefore one aggregated number is required under (f): the aggregate remuneration for people who meet that test. We also understand that the information regarding the fixed and variable components of remuneration (e) is to be disclosed on an aggregated basis for each component. We believe that CESR in its advice will need to specify more clearly the criteria that should be used by the AIFM to identify its staff members as per (e) and senior management and members of staff of the AIFM whose actions have a material impact on the risk profile of the AIF as per (f). However, the Directive anticipates that further detailed guidelines will be developed on remuneration generally and it may therefore be premature to define the scope of the requirements here.

- Fund managers typically manage multiple funds. Many members of AIFM staff (at all levels) will of course receive remuneration that does not relate to the work which they undertake in relation to any one particular fund. We assume that the Directive requires each AIF report to include the full amount of remuneration received by AIFM staff, even if it does not specifically relate to that AIF. However, it is clear that disclosure of carried interests (under (e)) is only required on a fund by fund basis and that the disclosure required here is an aggregated amount showing the total carried interest paid by the AIF to the AIFM during the period in question.

- The disclosure of remuneration on anything other than an aggregated basis would, in certain jurisdictions, result in considerably greater information than is currently required of listed entities and of non listed entities. Therefore it would be inappropriate to require such a breakdown of remuneration by function / senior employee within the filed accounts of AIF.

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- There are also issues for the many very small management groups which will be covered by these rules, where "aggregated" information may only cover one person (or a very small number of people) and it would be easy to see how much an individual received. We believe that there should be rules which do not require separate categories to be disclosed separately where there are a very small number of individuals in a particular category.

III. ISSUE 21 - ARTICLE 23 DISCLOSURE TO INVESTORS

1. With respect to the disclosure obligations in Article 23(4), CESR is requested to advise the Commission on:

- the appropriate frequency of such disclosures;
- the criteria for assessing the liquidity of assets and procedure for calculating the percentage referred to in Article 23(4)(a) and the format of such disclosures; the information and the essential elements to be included in the description of the arrangements referred in points a) and b) of Article 23(4) including the use of gates, suspensions and side pockets; the essential information, and the format thereof, of the risk factors, including relevant risk measures and metrics used to assess the sensitivity of the AIF portfolio to movements in interest rates, credit spreads, equity markets, etc, counterparty risks the extent of rehypothecation and information on indebtedness of entities controlled by the AIF to be disclosed by the AIFM to enable appropriate description of the current risk profile of the AIF; and
- the information and the essential elements to be disclosed by the AIFM to enable appropriate description of the risk management systems employed by the AIFM to manage these risks including results of recent stress tests.

CESR is requested to adapt its advice to the types of AIFM.

2. With respect to the disclosure obligations in Article 23(5), CESR is requested to advise the Commission on:

- the appropriate frequency of such disclosures;
- the essential information, and the format thereof, to ensure an appropriate description of changes to the maximum level of leverage which the AIFM may employ on behalf of the AIF as well as any right of re-use of collateral or any guarantee granted under the leveraging arrangement; and the leverage measures or ratios, and the format thereof, to be used by the AIFM when disclosing the total amount of leverage employed by the AIF during the reporting period and at the end of the reporting period including those specified according to Article 4.

CESR is invited to take the variation in the types of AIFM into account in its advice.

Response

It is clear that Article 23(4) is principally aimed at hedge funds, and other funds which have liquidity needs driven by investor demands for redemptions. Private equity and venture capital funds, which do not permit routine redemptions, do not have the same issues. It is important that any delegated acts make it clear that, so long as there is a clear disclosure that funds without redemption rights which invest in illiquid assets are adopting that business model, then the periodic disclosure requirements set out in Article 23(4) are satisfied by that initial disclosure.

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IV. ISSUE 22 – ARTICLE 24 REPORTING OBLIGATIONS TO COMPETENT AUTHORITIES

> **1. CESR is requested to advise the Commission for the purposes of paragraph 4 on the criteria to be used to determine under which conditions leverage is to be considered as being 'employed on a substantial basis'.**
>
> **2. CESR is requested to advise the Commission on the content of the obligations to report and provide information referred to in paragraphs 1 through 5. In its advice, CESR should**
>
> **3. consider developing a comprehensive template to be used by AIFM for reporting to competent authorities the information required under Article 24. In developing such a template, CESR should take into account the reporting template issued by IOSCO on 25 February 2010 for reporting from hedge funds and templates used by national competent authorities. CESR should address inter alia the following elements:**
>
> **- Assets under management**
> **- Performance and investor information**
> **- Market and product exposure (long and short positions)**
> **- Regional focus**
> **- Turnover and number of transactions, indication of markets in which trading can represent a significant proportion of overall volume, trading and clearing mechanisms**
> **- Leverage and risk**
> **- Asset and liability information**
> **- Counterparty risk**
>
> **The template should be sufficiently flexible to accommodate the different types, sizes and investment strategies of AIFM, without compromising the objective of effective supervision.**
>
> **4. CESR is requested to advise the Commission on:**
>
> **- the appropriate frequency of such reporting as a function of the potential risks posed by specific types of AIFM**
> **- the modalities and forms for data transmission; and**
> **- whether the same conditions should apply to the additional information requirements referred to in Article 24(5).**

<u>**Response**</u>

See our comments on the definition of leverage above.

V. ISSUE 23 – ARTICLE 25 USE OF INFORMATION BY COMPETENT AUTHORITIES, SUPERVISORY COOPERATION AND LIMITS TO LEVERAGE

> **1. CESR is requested to advise the Commission on the principles specifying the circumstances in which competent authorities shall exercise the powers granted pursuant to Article 25(3), taking into account different strategies of AIF, different market conditions in which AIF operate and possible pro-cyclical effects following from exercising the provisions. Such principles should guide competent authorities in identifying situations and circumstances in which competent authorities shall exercise the powers referred to in paragraph 3.**
>
> **2. In its advice, CESR should consider inter alia to what extent the following aspects might endanger the stability and integrity of the financial system:**

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- leverage used in different strategies and the size of an AIF's "footprints";
- the concentration of risks in particular markets and risks of spill-over effects; liquidity issues in particular markets; counterparty risks to credit institutions or other systemically relevant institutions; the scale of any asset/liability mismatch; and
- the evolution of prices of assets with respect to their fundamentals.

3. CESR is also requested to advise on the appropriate timing of potential measures referred to in Article 25(3).

Response

Article 25 is clearly aimed at funds whose actions can create systemic risk. Because of the business model of private equity and venture capital funds (no redemption rights, no fund level leverage, each investment obtains its own bank finance with no cross portfolio linkage or guarantees, no active trading etc) we do not believe that these funds create systemic risk and we believe that information relating to them does not need to be shared in accordance with the criteria set out for information sharing specified in paragraph 1. This view is further supported by a large number of independent reports on systemic risk which either do not include PE/VC at all or explicitly state that PE/VC do not pose systemic risk.

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PART IV

SUPERVISION

I. ISSUE 24 - COOPERATION ARRANGEMENTS BETWEEN EUROPEAN COMPETENT AUTHORITIES AND THE AUTHORITIES OF THIRD COUNTRIES

Issue 24a - Cooperation arrangements between European competent authorities and the authorities of third countries required by Articles 34(1), 36(1) and 40(1) AIFMD

1. CESR is requested to advise the Commission on a common framework to facilitate the establishment of the cooperation arrangements with supervisory authorities from third countries in the different situations described above. CESR is requested to advise on the objectives, the parties and the scope of the cooperation arrangements. In relation to the arrangements for the purpose of systemic risk oversight referred to in Articles 36(1) and 40(1), they should cover, at least, the minimum information related to the potential systemic consequences of non-EU AIFM activity that competent authorities should exchange with their non-European counterparts, the procedure for the exchange of that information and the frequency of the exchange. CESR is encouraged to consider as a framework the reporting obligations laid down in Article 24 AIFMD.

2. CESR should take into account that, due to the non-binding nature of the administrative arrangements, they should have a limited scope (i.e. cannot create legal obligations), since they cannot be considered as international treaties.

3. CESR is encouraged to take into account the relevant international standards in this regard, in particular, the principles and standards related to the control of the potential systemic risk posed by AIFM of the International Organisation of Securities Commissions (IOSCO).

Response

We strongly support the Commission's view that these Level 2 measures should be prioritised in order to ensure that all necessary cooperation agreements are in place on the date on which the Directive takes effect across the EU. We anticipate that a significant number of private equity and venture capital firms will seek to market funds under Articles 36 and 40 as soon as the Directive comes into effect, so it is vital that the necessary supervisory cooperation agreements are in place to avoid any *de facto* suspension of marketing activity and consequent market disruption.

In proposing a common framework to facilitate the establishment of supervisory cooperation agreements for this transitional period, we believe that ESMA should give high priority to ensuring that the framework is something to which both EU and non-EU supervisory authorities can readily sign up without unduly protracted negotiations. We suggest that, in the first instance, ESMA should consider whether the existing IOSCO multilateral memorandum of understanding is sufficient to fulfil the transitional requirements of the Directive.

Private equity and venture capital fund managers will commonly seek to raise capital from institutional investors globally, so it is often important for the fund to be incorporated in a jurisdiction that is largely 'neutral' for an international investor base. For that reason, where EU-based private equity and venture capital fund managers are managing and marketing non-EU funds, these funds are commonly (although by no means exclusively) established in the Channel Islands (Guernsey and Jersey) or the Cayman Islands. We therefore consider it would be beneficial for ESMA to work with the supervisory authorities in those

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jurisdictions as a priority to ensure that EU-based managers can continue to market such funds immediately after implementation of, and in accordance with, the Directive.

In relation to non-EU based fund managers, in our experience, EU-based investors most commonly (although by no means exclusively) seek to invest with US-based private equity and venture capital fund managers, typically into funds established in Delaware or the Cayman Islands, and also with Channel Islands based firms marketing Channel Islands funds. We would therefore suggest that ESMA should additionally work with the US supervisory authorities as a priority in order to ensure that EU-based investors can continue to access these funds immediately after implementation of the Directive.

Given the increasing trend towards investment in developing economies, particularly in Asia, we would also suggest prioritising at an early stage supervisory cooperation agreements with Hong Kong, Singapore, China, India and Mauritius (and we note that all these jurisdictions, other than Mauritius, are signatories to the IOSCO MMoU).

Finally, we would mention Switzerland as another non-EU jurisdiction that merits early consideration.

We would reiterate that, as supported by independent studies by de Larosière (February 2009) and the Turner Report (March 2009), the systemic impact of private equity and venture capital funds is low, and consequently our expectation is that the amount of information required to be exchanged pursuant to these agreements will be relatively limited.

Issue 24b - Cooperation arrangements between European competent authorities and the authorities of third countries required by Articles 35(2), 37(7)(d) and 39(2)(a) of AIFMD

1. CESR is requested to advise the Commission on a common framework to facilitate the establishment of cooperation arrangements with supervisory authorities from third countries in the different situations described above. CESR is requested to advise on the objectives, the parties and the scope of the cooperation arrangements. These arrangements should cover:

a) the modalities and conditions for the supervision of non-EU AIFM and funds and
b) the procedures for the exchange of information between the authorities involved.

The aim of these cooperation arrangements should be to ensure the efficient cooperation between supervisors and the effective supervision of the third country AIFM and/or AIF.

2. CESR should take into account that due to the non-binding nature of the administrative arrangements they should have a limited scope (i.e. cannot create legal obligations), since they cannot be considered as international treaties.

3. CESR is encouraged to take into account the international standards in this regard, in particular, the principles regarding cross-border supervisory cooperation of the International Organisation of Securities Commissions (IOSCO).

Response

We agree that these Level 2 measures might reasonably be adopted at a later stage. However, it is important that the process keeps moving forward to ensure that it is possible to make the passport available to non-EU AIF and non-EU AIFM across all EU jurisdictions in 2015.

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We would emphasise that the common framework established by ESMA needs to set parameters to which both EU and non-EU regulators can reasonably be expected to agree, and it is important that ESMA fulfils the coordination and facilitation role envisaged by the Directive.

II. ISSUE 25: COOPERATION AND EXCHANGE OF INFORMATION BETWEEN COMPETENT AUTHORITIES

1. CESR is requested to advise the Commission on the content of the level 2 measures on the exchange of information on the potential systemic consequences of AIFM activity. In particular CESR is requested to advise on what type of information could be exchanged among supervisors in order to facilitate supervisory cooperation in identifying potential systemic risks and risks to the orderly functioning of markets posed by AIFM individually or collectively, taking into account the reporting requirements on AIFM pursuant to Article 24.

2. CESR is requested to advise the Commission on a template, a data format, and the conditions of secured data transmission for the exchange of data among competent authorities. CESR is also requested to advise on the periodicity of the exchange of the information.

Response

We have no specific comment on the format or conditions for the exchange of information, but would make the following points:

- To the extent that the information to be exchanged between competent authorities is to be derived from regulatory reporting by AIFM, the implementing measures in relation to Article 51 should not extend the parameters set out in Article 24. Both competent authorities and ESMA should exercise the discretion granted by paragraph 5 of Article 24 only where this is clearly necessary as a result of prevailing market or economic conditions.

- We note that paragraph 1(a) of Article 40 requires non-EU AIFM to comply with Article 24 (Reporting obligations) during the transitional period in respect of funds marketed under Article 40, and that the prescribed information must be provided to the competent authorities in each Member State in which the fund is marketed. To minimise the additional administrative burden for non-EU AIFM, we would suggest that:

  - ESMA should prescribe a standard reporting form to be used by all competent authorities;

  - reporting dates and frequencies should be aligned so that all competent authorities require information to be submitted on common reporting dates; and

  - it should be possible to submit all reporting forms electronically (ideally through a centralised online system).

- We would also note that a number of the reporting items are not relevant to the majority of private equity and venture capital fund managers. For example, the requirement to report the principal markets on which an AIFM trades will not be relevant to a firm that invests only in unlisted private companies. It would therefore be useful if the reporting requirements and procedures were tailored to different types of fund where appropriate. As indicated above, the systemic impact of private equity and venture capital funds is low, and we believe this should be taken into account when determining the information to be collected and exchanged by competent authorities, and the frequency of reporting.

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III. ISSUE 26: AUTHORISATION OF NON-EU AIFM

1. CESR is requested to advise the Commission on the procedure to be followed by Member States when determining the Member State of reference in cases where there are several possible Member States of reference. This advice should discuss a number of alternatives. It should take the following aspects into account: legal certainty, risk of regulatory arbitrage and potential impact/costs on the AIFM, the investors in the AIF it manages, and the competent authorities involved.

Response

In our view, the provisions in Article 37 for determining a non-EU AIFM's Member State of reference are extremely complex, potentially creating sufficient legal and regulatory uncertainty to act as a disincentive to non-EU AIFM seeking authorisation under the Directive. To ensure that the EU remains globally competitive, it is essential that the Level 2 measures translate these complex legislative provisions into a straightforward and workable regime.

We would make the following comments:

- We anticipate that, in the majority of cases, non-EU AIFM will be managing and marketing non-EU funds, which will usually be marketed to professional investors in several EU jurisdictions. ESMA should issue clear, user-friendly guidelines to enable non-EU AIFM to determine their Member State of reference by applying a series of straightforward practical tests.

- It is not clear from paragraph 4 of Article 37 at which point in time an AIFM's intention should be assessed. In a private equity and venture capital context, it is likely that the AIFM will have only one fund that it intends to market immediately on obtaining authorisation, but it may well have a longer term intention to market a number of funds in the EU. We would suggest that intention should be assessed over the period of two years following authorisation, to align with the period in paragraph 11.

- Our expectation is that private equity and venture capital firms will usually fall within sub-paragraph (f) or sub-paragraph (h) of paragraph 4.

  - If sub-paragraph (h) applies, guidance is needed on what is meant by "the Member State where it intends to develop effective marketing for most of those AIF." It is not at all clear what this means, and in many cases, this statement is likely to be equally true, or untrue, for all Member States in which the non-EU AIFM intends to market fund interests. It would also be useful for ESMA to indicate what proof of this intention will be required from AIFM for the purposes of the last paragraph of Article 4.

  - If paragraph (f) applies, we would anticipate that most non-EU AIFM whose EU marketing activities are sufficient to justify commercially the costs and administrative burdens of obtaining authorisation under the Directive will be required under paragraph 4 of Article 37 to submit a request to the competent authorities of all the Member States that are possible Member States of reference to determine the Member State of reference among each other.

    - We would suggest that, for administrative convenience, ESMA should establish a central online application and notification system, rather than requiring a non-EU AIFM to contact each competent authority separately.

    - In many cases, there will be several (quite possibly 10, 12 or more) possible Member States of reference. Coordinating the views of such a number of competent authorities within the prescribed one month period will be challenging,

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and in the absence of a determination the non-EU AIFM may itself choose its Member State of reference based on the prescribed criteria. We would therefore suggest that the non-EU AIFM be given the opportunity to indicate a preferred Member State of reference (together with any supporting reasons) in its application, and that this preference should be taken into account when making a determination.

  - We respectfully submit that, where there are a number of possible Member States of reference but only some have entered into the necessary supervisory cooperation agreements and/or OECD tax information exchange agreements, only those Member States that have entered into the necessary agreements should be eligible for determination as the Member State of reference.

  - We respectfully suggest that ESMA could provide a non-exhaustive list of such reasons that the Member State authorities can take into account in determining the Member State of reference. These could include, for example, whether the AIFM has an affiliate in the preferred Member State that can act as the "legal representative", and common language.

- We query what role the procedure laid down in paragraph 5 of Article 37 serves where a determination of the Member State of reference has already been made under paragraph 4, and suggest that a competent authority should not refuse an authorisation request where it has been determined as the Member State of reference under the paragraph 4 procedure. For all other cases, we note that the paragraph 5 procedure could potentially be burdensome and time consuming. We would suggest that, to streamline the process and to avoid applications being unreasonably delayed (as the 'clock stops' during ESMA's review), the required information should be submitted to and assessed by both the relevant competent authority and subsequently to ESMA using prescribed forms, which should be straightforward to complete.

- We believe that a dispute as to the correct Member State of reference should be permitted to arise only in exceptional cases. To the maximum extent possible, an AIFM acting in good faith and on reasonable commercial grounds should not be caught in the middle of a dispute between competent authorities and/or ESMA as a result of the procedures laid down in paragraphs 5 and 6 of Article 37, particularly where this would prevent the AIFM from commencing its marketing programme.

- We note that a change in Member State of reference is likely to result in significant costs and administrative burdens to a non-EU AIFM. For example, as there will invariably be some difference in practice between competent authorities, it is likely to be necessary to appoint new legal counsel, and to obtain local legal and compliance advice in the new Member State of reference, duplicating substantial work that will already have been undertaken. It would also be necessary to appoint a new legal representative in the new Member State of reference, potentially requiring the firm to establish a new affiliated entity in the new Member State of reference to perform this role, or to change third party providers. As described above, the marketing focus of a private equity and venture capital firm may change during fundraising depending on investor appetite. Provided that the non-EU AIFM has determined its initial Member State of reference in good faith and on appropriate grounds, it should not be required to change its Member State of reference because fundraising does not pan out as expected (for example, if few or no prospective investors in the Member State of reference ultimately decide to invest); this should not be viewed as a 'change in marketing strategy' for the purposes of paragraph 11(a) of Article 37.

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Additional Comments

Articles 31/32/35/38/39

- The information to be provided to the relevant competent authority prior to marketing (as specified in Annex III to the Directive) includes the AIF rules or instruments of incorporation, and any material changes are required to be notified to the relevant competent authority at least one month in advance of implementation. In the private equity and venture capital context, because the 'product' does not exist in advance of marketing (it will be created only if fundraising is successful), it is not usual for the limited partnership agreement or equivalent document to be prepared for some time after marketing has commenced, in part to avoid incurring significant legal costs until it is clear that there is investor appetite for the product, and in part because key terms and conditions may change in response to discussion with prospective investors. Once prepared, the draft document will be subject to intensive negotiation by investors, and will often be agreed only days, or even hours, before investors contractually commit to the fund. If investors are admitted in a series of 'closings', it is also possible that the agreement entered into at 'first closing' will subsequently be amended at 'final closing'. Insofar as possible within the parameters of the Directive, we would ask ESMA and competent authorities to take into account these commercial issues when implementing the notification requirements contained in Articles 31, 32, 35, 38 and 39.

- We note that, in addition to supervisory cooperation agreements, OECD Tax Information Exchange Agreements must be in place between the relevant jurisdictions before a non-EU fund can be marketed under the passport. We would ask ESMA to encourage and facilitate the entry by Member States into these agreements with those non-EU jurisdictions that are willing to do so, to ensure that the passport is available across all EU jurisdictions in 2015. We would further encourage ESMA to consider interim arrangements where these agreements are not in place on time.

Article 37

In addition to our comments above in relation to determining the Member State of reference, we would add the following:

- It would be useful to have clarification of the basis on which the exemptions in paragraph 2 of Article 3 will apply to non-EU AIFM (in particular, what assets under management are to be included when determining whether the threshold for authorisation is met, and how the national registration requirements apply (if at all) to smaller non-EU AIFM).

- In advance of 2015, it will be necessary to set out in detail how the requirements of the Directive as a whole will be applied to authorised non-EU AIFM. Recital (11) indicates that, for non-EU AIFM, the requirements of the Directive are "limited to the management of EU AIF and other AIF the units or shares of which are also marketed to professional investors in the European Union." However, the Directive does not clearly indicate how this proportionality requirement should operate in relation to, for example, calculating a non-EU AIFM's regulatory capital requirement, or the general operating and organisational requirements in Chapter III of the Directive.

- In relation to paragraph 2(ii) of Article 37, it would be extremely helpful if ESMA could work with regulators in key jurisdictions (for example, the US Securities and Exchange Commission) to identify any areas in which the securities laws of those jurisdictions are incompatible with any provision of the Directive but there is an equivalent rule having the same regulatory purpose and offering the same level of protection to investors, so that non-EU AIFM from those jurisdictions are able to follow a standard path when seeking authorisation in the EU, rather than being required individually to commission a (very costly and time consuming) full comparative legal review of the securities laws in each

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jurisdiction and then to make the case to ESMA for an individual waiver. Where incompatibility of laws would, in effect, make it impossible for a non-EU AIFM from a particular jurisdiction to obtain authorisation in the EU, we would ask ESMA to work with the relevant local bodies to resolve these inconsistencies. We believe it would be desirable for ESMA to complete this work in relation to key jurisdictions prior to 2015, and it is essential that this work is undertaken before any termination of national private placement regimes to avoid an effective 'lock-out' of non-EU AIFM from the European market.

- We foresee that a requirement for a non-EU AIF managed by a non-EU AIFM with primarily non-EU (but some EU) investors to appoint an EU depositary could give rise to a number of practical issues. It would therefore be helpful to know, at the earliest possible stage, whether or not ESMA considers that depositaries in key non-EU fund jurisdictions meet the requirements of paragraph 5(b)(ii) of Article 21.

- In relation to the second sentence of paragraph 12 of Article 37, a number of difficult conflicts of laws issues arise. A non-EU AIF will necessarily be constituted under the laws of a non-EU jurisdiction, and there is an extent to which that law will necessarily determine relations between investors and the AIFM. Clarification is therefore required as to how this provision is intended to operate.

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