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Mr. Steven Maijoor
Chair
European Securities and Markets Authority
103, rue de Grenelle
75007 Paris
France

Brussels, 13 September 2011

Re: Consultation on ESMA technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive

Dear Mr. Maijoor,

CFA Institute[1] is pleased to comment on the consultation ESMA launched for its "draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive" ("AIFMD"). The mission of CFA Institute is to lead the investment profession globally by setting high standards of education, integrity, and professional excellence. CFA Institute represents the views of investment professionals before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and on issues that affect the efficiency and integrity of global financial markets.

Executive Summary

The investor protection objective of the AIFMD is consistent with the commitment of CFA Institute and its more than 107,000 members to protecting investors and putting the interests of clients first. This commitment is reflected throughout the CFA Institute Code of Ethics and Standards of Professional Conduct[2].

[1] CFA Institute is a global, not-for-profit professional association of more than 107,000 investment analysts, advisers, portfolio managers, and other investment professionals in 137 countries, of whom almost 96,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 135 member societies in 58 countries and territories.

[2] http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2010.n14.1
All CFA Institute members and CFA candidates must abide by the Code of Ethics and Standards of Professional Conduct, and violations may result in disciplinary sanctions by CFA Institute.

In an October 2009 survey of its membership on alternative investment funds[3], to which 1,279 members responded, 91% of respondents said that managers of alternative investment funds that are marketed to retail investors should be subject to regulatory authorization and registration, as compared with 60% for managers of alternative investment funds that are marketed to professional investors. Also, 97% of respondents supported mandatory requirements for managers of AIFs to act honestly, with due skill, care and diligence, to treat investors fairly and to act in the best interests of investors.

CFA supports the overall approach taken in the draft technical advice of ESMA to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive (AIFMD) adopted on 8 June 2011. In particular, CFA Institute supports the overall efforts to make these implementing measures consistent with those already adopted for Undertakings for Collective Investments in Transferrable Securities ("UCITS") and in the Markets in Financial Instruments Directive ("MiFID"), while taking into account the very diverse characteristics of AIFs in terms of size, strategy and structure.

CFA Institute also believes that, to ensure that managers of AIFs or UCITS act in the best interests of their investors and the integrity of the market, the implementing measures of the AIFM and UCITS Directives would be efficiently complemented by the adoption by managers of a high-quality, global, well-recognized as well as comprehensive and specific code of conduct that outlines the ethical and professional responsibilities of firms that manage assets on behalf of clients. As discussed more fully below, we recommend consideration of the CFA Institute Asset Manager Code of Professional Conduct for this purpose. The voluntary adoption of such a code by AIFMs should be recognized by competent national authorities as one means for AIFMs to demonstrate that they "act in the best interests of the AIFs or the investors of the AIFs and the integrity of the market", as required under Article 12(1) of the AIFMD.

The following comments address proposed requirements in terms of General Operating Conditions (sections IV.II-IV.IX) and Transparency Requirements (sections VIII.I-VIII.II). We have focused our responses to the consultation to those elements on which we thought our input would be valuable to ESMA, meaning that not all sections of the consultation have been addressed.

General Discussion

IV.II. Possible Implementing Measures on General Principles [Boxes 10-19]

The Commission has requested that ESMA advise it on criteria to be used by the relevant competent authorities to assess whether managers subject to AIFM comply with their obligations under Article 12(1) of the Directive.

In principle, CFA Institute agrees with ESMA that the implementing measures for the "conduct of business rules" of Article 12(1) AIFMD should be consistent with those Level 2 measures of UCITS and MiFID, to avoid inconsistencies – particularly when an AIFM also manages UCITS – and to facilitate the implementation of these measures by the industry, and

[3] http://www.cfainstitute.org/Survey/alternative_investment_fund_survey_report.pdf

potentially their monitoring by the competent authorities. Still, the implementing measures should reflect the specificities of AIFMDs.

Box 10: Duty to act in the best interests of the AIF or the investors of the AIF and the integrity of the market

In an October 2009 survey of 1,279 CFA Institute members[4], 97% percent of respondents supported mandatory requirements for AIFMs to act honestly, with due skill, care and diligence; to treat investors fairly; and to act in the best interests of investors.

Under Box 10, CFA Institute believes that one criterion that relevant competent authorities could apply to verify that AIFMs "act in the best interests of the AIF or the investors of the AIF and the integrity of the market" is for AIFMs to adopt a high-quality, global, well recognized as well as comprehensive and specific code of conduct. To meet these requirements, such a code would need to outline the ethical and professional responsibilities of firms that manage assets on behalf of clients.

The Asset Manager Code of Professional Conduct[5] ("AMC") of CFA Institute is recognized as a high-level, detailed and practical Code of Conduct for investment managers. It has been adopted by 567 asset management firms globally, in countries such as Germany, Spain, Ireland, UK, Switzerland. This Code sets forth minimum ethical standards for providing asset management services for clients and provides standards and supportive guidance based on general principles of conduct.

The AMC states that managers have these responsibilities to their clients:

- To act in a professional and ethical manner at all times
- To act for the benefit of clients;
- To act with independence and objectivity;
- To act with skill, competence, and diligence;
- To communicate with clients in a timely and accurate manner, and
- To uphold the rules governing capital markets.

The AMC is comprehensive as it covers six broad categories:

- Loyalty to clients;
- Investment process and actions;
- Trading;
- Risk management, compliance and support;
- Performance and valuation; and
- Disclosures.

[4] http://www.cfainstitute.org/Survey/alternative_investment_fund_survey_report.pdf
[5] http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2009.n8.1

Each category outlines the professional conduct expected of investment managers and contains ethical standards that define the responsibility of managers when providing asset management services for investors, which can be put in practice in a straightforward way.

CFA Institute acknowledges that EU regulations such as AIFMD, UCITS and MiFID already include obligations for investment firms to always act in the interest of investors. Adoption and implementation of a Code of Conduct like the AMC can provide, in some instances, more specific and practical information on what is ethical / not ethical and what should be done. Examples include:

- "Managers must give priority to investments made on behalf of the client over those that benefit the Managers' own interest". Recommendations and guidance in this regard include: "Managers must not execute their own trades in a security prior to client transactions in the same security"; "Managers should develop policies and procedures to monitor and, where appropriate, limit the personal trading of their employees. In particular, Managers should require employees to receive approval prior to any personal investments in IPOs or private placements. Managers should develop policies and processes designed to ensure that client transactions take precedence over employee or firm transactions". …
- "Managers must use commissions generated from client trades to pay for only investment-related products or services that directly assist the Manager in its investment decision making process, and not in the management of the firm."
- Managers must disclose "management fees and other investment costs charged to investors, including what costs are included in the fees and the methodologies for determining fees and costs".

The voluntary adoption of a code like the AMC should therefore be recognized by competent national authorities as one means for AIFMs to demonstrate that they "act in the best interests of the AIFs or the investors of the AIFs and the integrity of the market", as required under Article 12(1) of the AIFMD.

An additional key advantage of such a code is that it can more easily and quickly be adapted to changing evolving markets and practices and integrate possible lessons learnt from potential crises than regulations.

A criterion on whether or not an AIFM claims compliance with a broadly recognized code of conduct could be practical as it would be easily checked by the competent national authorities to meet their duty to assess whether AIFM comply with their obligations under Article 12(1) of the AIFMD.

Finally, CFA Institute believes that one duty missing from Article 12(1) of the AIMD is the duty to preserve the confidentiality of information communicated by the investors of the AIFs within the scope of the AIFMD-investor relationship. Such an obligation would include the need to create a privacy policy that addresses how confidential investor information will be collected, stored, protected and used. Unless this is covered by another EU regulation, we recommend that this be reflected in the implementing rules of AIFMD.

Box 11: Due diligence requirements

Due diligence requirements as suggested by ESMA in Box 11 seem high-level enough to address our concern that they do not translate into a list of specific and detailed due diligence requirements Still, we would advise ESMA to consider introducing in the text the clarification that this list of due diligence requirements is not exhaustive and that the AIFM has the responsibility to implement any due diligence needed for him to fulfill the mandate given to him by the investor. The first three due diligence requirements suggested by ESMA in Box 11 are in line with the first three due diligence requirements for UCITS (Directive 2010/43/EU). Nevertheless, the reference to management of risk is limited and could, in our view, be strengthened. One possible way to achieve this goal would be by modifying the second due diligence requirement to read that "AIFM should ensure that they have adequate knowledge and understanding of the assets in which the AIF is invested, notably in terms of risk".

Q16: Paragraphs 4 and 5 of Box 11 set out additional due diligence requirements with which AIFMs must comply when investing on behalf of AIFs in specific types of asset e.g. real estate or partnership interests. In this context, paragraph 4(a) requires AIFMs to set out a 'business plan'. Do you agree with the term 'business plan' or should another term be used?

The list of due diligence requirements for AIFMs investing in specific types of assets such as real estate or partnership interests, as suggested by ESMA in paragraphs 4 and 5 of Box 11, seems to us to be a bit specific. In particular, we are concerned that the additional requirements 4(a) to 4(e) would be seen by firms as the entirety of their obligations, and could act to shelter AIFMs from liability. Moreover, over time, ESMA may need to update these requirements as new investment products develop. We therefore suggest that it would be more appropriate for ESMA to keep any due diligence requirements at a higher level.

With regard to question 16 on terminology in CFA Institute believes that the term "investment plan" would be more appropriate, notably because the term "business plan" does not fit with real estate investments.

Box 12: Reporting obligations in respect of execution of subscription and redemption orders

CFA Institute agrees that the language on reporting obligations in respect of execution of subscription and redemption orders should be based on MiFID implementing measures for professional investors. We believe this will ensure consistency between the obligations under both Directives.

Box 13: Selection and appointment of counterparties and prime brokers

It is not clear to us why the definition of counterparty here is limited to OTC transactions in securities lending or repurchase agreements. We believe it would make sense to expand the definition to include other transactions in financial instruments such as, for example, swaps and derivatives.

Box 14: Execution of decisions to deal on behalf of the managed AIF

We believe it is appropriate to make execution obligations under AIFMD consistent with those of UCITS and MiFID. Such requirements should still recognize the fact that there is no choice of different execution venues for assets such as real estate and partnership interests.

The criteria for determining the relative importance of factors of best execution for AIFM (price, costs, speed, likelihood of execution and settlement, size, nature) should be in line with those detailed in Article 25 of UCITS Level 2.

Box 15: Placing orders to deal on behalf of AIFs with other entities for execution

Keeping the investors' interests in mind, CFA Institute believes that the language should specify that "whenever AIFMs buy or sell financial instruments or assets, they should act in the best interests of the AIF they manage <u>and the investors of the AIF under their management</u>".

Again, CFA Institute believes that it would assist competent authorities to assess whether AIFMs comply with their obligations under Article 12(1) of the AIFMD if a criterion on whether or not an AIFM claims compliance with a broadly recognized code of conduct such as the AMC was included. Doing so could help promote ethical behaviour among AIFMDs and further protect investors' interests.

Box 16: Handling of orders – general principles

Box 17: Aggregation and allocation of trading order

CFA Institute agrees that AIFMs' obligations in terms of handling of orders, and aggregation and allocation of trading order, as described in Boxes 16 and 17, should be consistent with those obligations under UCITS.

Box 18: Inducements

CFA Institute strongly supports the view that more transparency on payment of fees, costs, commissions or inducements will enhance investors' protection and improve the trust of investors in asset management firms. To that end, CFA Institute states in its AMC that asset managers should disclose (i) management fees and other investment costs charged to investors, including what costs are included in the fees and the methodologies for determining fees and costs, and (ii) the amount of any soft or bundled commissions, the goods and/or services received in return, and how those goods and/or services benefit the client.

Box 19: Fair treatment by an AIFM

Q17: Do you agree with Option 1 or Option 2 in Box 19? Please provide reasons for your view.

If we understand correctly, this box refers to Article 12 (1)(f) asking Member States to ensure that AIFMs "treat all AIF investors fairly", and to the request by the Commission to ESMA for advice in establishing the criteria to be used by competent authorities in assessing fair treatment.

CFA Institute believes that neither Option 1 ("Fair treatment by an AIFM requires that no investor may obtain a preferential treatment that has an overall material disadvantage to other investors") or Option 2 ("Fair treatment by an AIFM includes that no investor may obtain a preferential treatment that has an overall material disadvantage to other investors") is appropriate.

In general, we find both options as potentially too restrictive on AIFMs. As noted in the AMC, CFA Institute believes it is acceptable that AIFMs may offer higher levels of service or certain services to clients, or make certain products available only to certain qualifying clients (e.g., certain funds may only be open to clients with investable funds above a certain level). AIFMs must disclose such practices and make them available to all clients. Beyond this, and certainly within a class of investors, we believe that managers must deal with all clients in a fair and objective manner and avoid giving preferential treatment to favored clients to the detriment of other clients.

Furthermore, as noted in the AMC, AIFMs should be able to engage in secondary investment opportunities – referred to in some jurisdictions as "side letter", "sidecar", or "tag-along" arrangements – with certain clients. Such arrangements are appropriate as long as such opportunities are fairly allocated among similarly situated clients for whom the opportunity is suitable.

IV.III. Possible Implementing Measures on Conflicts of Interests [Boxes 20-24]

Box 20: Types of conflicts of interests between the various actors as referred to in Article 14(1)

Conflicts of interest often arise in the investment management profession and can take many forms. CFA Institute agrees with the text proposed by ESMA in Box 20, which provides a list of criteria to be considered to identify potential conflicts of interests (including the possibility for the AIFM or any person linked to the AIFM to make a financial gain or avoid a financial loss, or to have an interest in the outcome of a service or activity provided to the AIF). As written, it is sufficiently comprehensive and specific, and is consistent with the criteria for identifying conflicts of interests under UCITS implementing measures.

Box 21: Conflicts of interest policy

To enhance investors' protection, it is necessary for AIFMs to have an effective conflicts of interest policy in place. We believe that requirements in that regard should be consistent with requirements under UCITS Level 2.

Box 22: Independence in conflicts management

Box 23: Record keeping of activities giving rise to detrimental conflicts of interest and way of disclosure of conflicts of interest

In relation to Boxes 22 and 23, as emphasized in CFA Institute's Code of Professional Conduct, best practice is to avoid conflicts of interests. However, when managers cannot reasonably avoid conflicts, they must carefully manage them and disclose them to clients. Disclosure of conflicts of interests protects investors by providing them with the information they need to evaluate the objectivity of their managers' investment advice and actions taken on behalf of clients. It also gives investors the information they need to judge the circumstances, motives, and any possible Manager bias.

Box 24: Strategies for the exercise of voting rights

CFA Institute agrees with the text proposed by ESMA, requiring AIFMs to develop adequate and effective strategies for determining when and how any voting rights held in the managed portfolios are to be exercised. This is in line with UCITS provisions.

IV.IV. Possible Implementing Measures on Risk Management [Boxes 25-30]

CFA Institute believes that appropriate risk management is an essential duty of AIFMs towards their investors. A transparent, robust framework for managing risks is key to protecting investors' interests and maintaining confidence in the AIF industry.

Box 25: Permanent Risk Management Function

CFA Institute strongly supports the establishment of a permanent risk management function that has the necessary resources, independence and authority to fulfill the obligations of the AIFM towards investors. The tasks of such as a permanent risk management function as described in Box 25 are comprehensive, even though CFA Institute has a reservation on the risk limits (see below comment under Box 29).

We also believe that if ESMA were to retain its advice in 1(b) requiring the permanent risk management function to "ensure that the risk profile of the AIF disclosed to investors … is consistent with the risk limits that have been set in accordance with Box 29", then it should be amended to state, "the AIFM shall establish and maintain a permanent risk management function that shall ensure that the risk limits that have been set in accordance with Box 29 are consistent with the risk profile disclosed to investors in accordance with Article 23(4)c of Directive 2011/61/EU." Indeed, it seems to us that the AIFM should first define the risk profile, and then on this basis determine the risk limits– not the other way around.

Box 26: Risk Management Policy

CFA Institute believes that an efficient risk management framework starts with a solid risk assessment and risk management policy. Consequently, we broadly support ESMA's guidelines as described in Box 26. However, we believe it is important that this framework provides flexibility for implementation that reflects that heterogeneous population of AIFs in terms of size, strategy and structure.

Box 29: Risk Limits

In general, CFA Institute agrees that risks limits defined on the basis of the risk profile disclosed in the AIF's rules, status of incorporation, prospectus or offering documents could be helpful to ensure a proper management of risks by AIFM. However, we believe it is important to emphasize that it is ultimately up to the investors to decide what level of risk they are willing to accept in expectation of a certain level of return.

It is therefore essential that any change in the risk profile of an AIF is communicated to investors, particularly when dealing with retail investors. ESMA's advice is for AIFM Level 2 to include the requirement that the AIFM establishes qualitative and quantitative risk limits covering at least five risks: market risk; credit risk, liquidity risk; counterparty risk, and operational risk. What is unsettling to CFA Institute is that requirements for the permanent risk management function are more specific and stringent for AIFs than under UCITS Level 2 (Directive 2009/65/EC, Article 12), which seems inconsistent with the fact that UCITS are marketed to retail investors CFA Institute believes that the requirements for AIFs should be consistent with those under UCITS in order to avoid regulatory arbitrage.

IV.V. Possible Implementing Measures on Liquidity Management [Boxes 31-34]

CFA Institute believes that, while liquidity risk is an essential risk in asset management, it has to be acknowledged from the onset that liquidity requirements vastly differ from one AIF to another. What is essential is that: (i) investors are duly informed and fully understand the liquidity profile and characteristics of the AIFs they are investing in, and (ii) the liquidity management policy of the AIF is consistent with its redemption terms – and amendments thereof.

Box 34: Alignment of investment strategy, liquidity profile and redemption policy

Q22: Do you agree with ESMA's proposed advice in relation to the alignment of investment strategy, liquidity profile and redemption policy?

Under the AIFM Directive, AIFMs are required that "for each AIF they manage, the investment strategy, the liquidity profile and the redemption policy are consistent".

CFA agrees with ESMA's proposal that investment strategy, liquidity profile and redemption policy shall be considered in alignment when investors have the ability to redeem their investments (a) in a manner consistent with the fair treatment of all AIF investors; and (b) in accordance with the AIF redemption policy.

IV.VI. Possible Implementing Measures on Investment in Securitisation Positions [Boxes 35-43]

Box 35: Requirement for retained interest

Article 17 of the AIFMD includes the requirement that AIFM only assume exposure to tradable securities and financial instruments based on repackaged loans if the originator, sponsor or original lender agrees to retain a 5% net economic interest.

CFA Institute supports ESMA's overall objective of implementing regulations that do not encourage regulatory arbitrage and thus supports proposed measures that AIFMs should generally be subject to substantially the same regulations that apply to managers of UCITS. We also believe that a certain level of consistency is ensured with measures in the Capital Requirements Directives and Solvency II.

We have a longstanding position of supporting regulations that do not disadvantage one group of market participants relative to another but instead create a level playing field. Given the additional concerns that securitised loans and financial packages raise, we applaud the ESMA for applying the AIFM requirements in this area also to managers of UCITS. We believe that securitised products raise similar issues for both AIFs and UCITS, to which the proposed regulations speak.

CFA Institute also supports the overarching theme in the proposed requirements for retained interest. In particular, ESMA proposes to require an AIFM to take corrective action in the best interests of its investor when it realizes an inaccuracy of assumptions underlying the disclosure of the net economic interest, or that the retained interest falls below 5% (para. 3 of Box 35).

We suggest that the final provisions provide that AIFMs take action "as soon as practically possible" after discovery of such matters, while seeking to ensure that such actions are in the long-term best interests of investors in the fund.

IV.VII. Possible Implementing Measures on Organisational Requirements [Boxes 44-54]

Box 44: General requirements on procedures and organisation

Similarly, we also agree with the approach taken by ESMA in seeking to align the responsibilities of managers to AIFs with those under UCITS and MiFID. At the same time, this approach should realize that certain organizational requirements should consider the complexity and range of AIF activities—the so-called principle of proportionality. To that end, we generally agree with the proposed general procedures and organization requirements.

Box 45: Resources

Box 45 directs AIFMs to employ personnel that have the requisite skills and expertise to carry out their responsibilities. We suggest that ESMA add that resources should also be focused on/expended for managing conflicts of interest.

Box 48: Control by senior management and supervisory function

CFA Institute strongly supports the requirements in Box 48 that seek to establish an oversight regime wherein senior management assumes responsibility for ensuring compliance and risk management functions (even if performed by a third party). We also strongly support periodic reviews focused on consistency with the AIF's defined investment strategies and risk management policies.

We believe these are important and appropriate responsibilities for senior management to undertake. Not only does the assumption of these duties establish the "tone from the top," but also vests senior management with basic responsibilities for ensuring that basic investor protections are being safeguarded.

In this regard, we suggest that final rules define how frequently (versus "on a regular basis") the AIFM will ensure that senior management will receive reports on the implementation of investment strategies and of the internal procedures for taking investment decisions, as noted in paragraph 5. Under paragraph 6, we also suggest to clarify the "regular basis" on which the supervisory function, if any, should receive written reports on the matters noted in paragraph 4.

Box 49: Permanent compliance function

The last sentence in Box 49 states, "However, an AIFM shall not be required to comply with point (c) or point (d) of the first subparagraph where it is able to demonstrate that in view of the nature, scale and complexity of its business, and the nature and range of its services and activities, that requirement is not proportionate and that its compliance function continues to be effective." This language is confusing.

We understand that ESMA's objective is, depending on the size and complexity of the AIF, to allow the AIFM not to comply with the obligations in paragraphs 3(c) and 3(d). Explanation note 16 seems to say that if the AIF is small and not complex, the AIFMD does not have to abide by the rule to maintain objectivity and notably comply with the requirements in 3(d) for determining pay for compliance personnel. Such small and less-complex AIFMs can avoid the requirement as long as the reasons for using the exemption are provided.

We believe this exemption must be revised to ensure that such AIFMs are still subject to the objectivity obligations of the relevant paragraphs.

Box 51: Personal Transactions

While UCITS Level 2 only refers to personal transactions with financial instruments, we support ESMA's approach to expand the reach of personal transactions prohibitions to also include personal transactions with other assets. We believe this is an appropriate expansion of the scope of prohibited conduct.

However, the term "family relationship" used in the box is undefined, which may create confusion. It may be appropriate for ESMA to consider appropriation of the definition of "member of the immediate family" as used in the Investment Company Act of 1940 that regulates US mutual funds. The definition used there refers to "any parent, spouse of a parent, child, spouse of a child, brother or sister, and includes step and adoptive relationships."

Complaints handling

Q23: Should a requirement for complaints handling be included for situations where an individual portfolio manager invests in an AIF on behalf of a retail client?

With the view of increasing investor protection, CFA Institute supports a requirement for handling complaints where the portfolio manager is making the investment in an AIF on behalf of a retail client. We acknowledge that Article 10 of MiFID Level 2 requires investment firms to only establish procedures for complaints from retail clients. At the same time, we are concerned that there is no requirement to establish procedures for handling complaints from institutional investors, which we encourage ESMA to include.

IV. VIII. Possible Implementing Measures on Valuation [Boxes 55-62]

CFA Institute agrees with the proposed mandate that the AIFM should have and maintain policies and procedures that ensure a "sound, transparent and appropriately documented" valuation process. The integrity of this process must be upheld for investors and counterparties, alike, to have confidence that the assets in the AIF are being properly valued and their underlying worth fairly represented.

As drafted, the Directive would allow AIFMs to use an external valuer or be subject to additional safeguards if performing the valuation itself. We appreciate the attention to trying to build in these safeguards which would include "measures to prevent or limit any person from exercising inappropriate influence over the way in which a person carries out valuation activities." However, given the importance of adequate valuation for investors, CFA Institute members would favour all but the smallest AIFMs being required to employ an independent third party to perform this valuation. We believe this is a better option than those provided in the Directive that would also allow the AIFM itself to perform the valuation function.

In a survey of CFA Institute members in October 2009 on AIFM, 80% of respondents in the EU felt that AIFMs should have to appoint an independent third party to perform the valuation of assets. Some respondents who favour the use of an independent third party to perform valuations noted that especially with illiquid assets, having the valuation performed by an independent party will increase the credibility and marketability of the valuations. Others noted the benefits that added transparency and objectivity from such a requirement would bring. Still others felt that AIFMs were not likely to fully manage the inherent conflicts of interest internally.

Moreover, 71% of EU respondents expressed the belief that an independent third party should retain control over the process used to determine a final valuation. The added transparency and credibility that such a requirement would bring to the process was cited by respondents as the reason for this perspective. They also said that the methodology for valuation should be disclosed to investors.

At the same time, 48% of EU-based respondents did not think it appropriate to place restrictions related to the location of independent valuators (depositaries and portfolio managers) of AIFs sold in the EU, versus 33% who did find it appropriate. (65% of non-EU respondents favoured no restrictions while 17% of non-EU respondents did).

IV.IX. Possible Implementing Measures on Delegation [Boxes 63-73]

CFA Institute appreciates and supports the emphasis in this section on protecting the best interests of investors. We believe that the proposed requirements generally seek to ensure that where all or some of the AIFM's tasks are delegated, the AIFM retains responsibility for its obligations towards its investors.

We also support the explicit requirements that the AIFM must establish effective methods for overseeing and ensuring that the delegated functions are performed appropriately and in accordance with applicable laws and regulations. Likewise, we support the proposal that senior management must remain responsible for all delegated tasks.

Q24: Do you prefer Option 1 or Option 2 in Box 65? Please provide reasons for your view.

In general, we favor Option 1 with regard to an AIFM's delegation of its duties (Q24). Under this option, AIFMs must "demonstrate that the delegation is done for the purpose of a more efficient conduct of the AIFM's management of the AIF."

We believe that this language more fully captures the reasoning behind the ability to delegate AIFM responsibilities and affords the AIFM needed flexibility to meet this requirement. Nevertheless, we suggest that the four "objective reasons for delegating tasks" provided in Option 2 also should be included as guidance in the final implementing regulations. We believe they are useful examples of the types of analyses AIFMs should perform in justifying delegation of duties. Specifically, these four reasons include: optimizing of business functions and processes; cost savings; expertise of the delegate in administration/specific markets/investments; and access of the delegate to global trading capabilities

VIII. I. Possible Implementing Measures on Annual Reporting [Boxes 101-105]

Q63: Do you agree with the approach in relation to the format and content of the financial statements and the annual report? Will this cause issues for particular GAAPs?

We understand that ESMA is making the following proposals, through the advice outlined in Boxes 101-105:

- Investment entities should be exempt from consolidation requirements, if national law or national GAAP permits such exemption.
- Material changes for financial reports should be highlighted and this should be based on a principles-based definition of materiality.
- Prescribing key elements of financial statement presentation through the balance sheet and income statement. It also requires that the presentation of the cash flow statement issuance should be discretionary depending on whether it is required by national GAAP requirements, and also by the nature and size of the AIF.
- Outline of the content and format for reporting key activities during a financial year.

General comments

We observe that the above ESMA proposals are being made against the backdrop of the issuance of the International Accounting Standards Board's (IASB) IFRS 10 Exposure Draft (ED), *Investment Entities*. IFRS 10 would require that qualifying investment entities be exempt from consolidating their investee companies. Instead, the investment entity would be required to measure the fair value of all investments through profit and loss. In this respect, the ESMA proposals related to recognition of investment entities seem to be congruent with those made by the IASB, in as far as not requiring parent investment entities to consolidate their investments.

Despite this observation, there is a general need for ESMA and the EC to align their overall efforts towards improving investment entities reporting, with the improvements being proposed through various IFRS amendments. The issues addressed in the ESMA consultation overlap with: IFRS 10 and other IFRS literature on financial statement presentation (IAS 1 and IAS 7) and management, discussion and analysis. An alignment of reform efforts is necessary in order to ensure consistent and comparable reporting practices by investment entities, across EU states. In effect, the ESMA consultation should only be complementary and be used to augment the IASB efforts, as opposed to being duplicative.

Below are specific comments on (a) recognition and measurement of investments; (b) financial statement presentation, and (c) disclosures of key changes and activities during a reporting period.

Recognition and measurement of investments

We agree with the requirement to exempt investment entities from consolidating their investments and support an approach where all investment entities report their investments at fair value through the profit and loss statement. This would be as proposed by the IFRS 10 ED.

From an investor standpoint, the overriding consideration of reporting guidance should be to ensure the provision of: a) consistent and comparable reporting by all investment entities; and b) the most relevant and decision-useful information derived from a sound conceptual justification.

In this respect, we are concerned by the language used by the ESMA recommendation in Box 102 and the explanatory text paragraphs 13 and 14. In these instances, the basis of exemption from consolidation requirements is that of conformity with nation-specific GAAP or law. Even though it may be that, in this particular instance, conforming to national EU GAAP allows more useful information, the general principle of allowing country-specific exemptions is harmful to investor interests, as it negates the issuance of comparable financial reporting across EU jurisdictions.

Hence, we recommend that the financial reporting reform should be designed and primarily based on a sound conceptual justification and not due to either country-specific or industry-specific exemptions. In a previous comment letter[6], we provided such a conceptual justification noting that the objective of investors in investment companies is to earn returns on their investments. Investors bear all of the upside and downside risk of the investments and are interested in knowing the investments held by the company and the change in fair value of those investments over time. Net asset value, the change in net asset value (often in comparison with a benchmark) and fee structures are the primary metrics that shareholders use to evaluate the performance of investment companies and to make buy or sell decisions.

The fair value recognition would require supplementary disclosures when an investment company bears direct or indirect legal and/or economic responsibility for some or all of the liabilities; then supplementary disclosures should be required to inform shareholders of the additional risk. Similarly, disclosures of gross assets and liabilities held by investee

[6] CFA Institute Comment Letter: *Follow up to Meeting with Board 16 October: Consolidation Policy for Investment Companies and Investment Managers* (2 November 2009).

companies should be required if these investee companies are not publicly traded or have limited disclosure related to their liabilities in the public domain.

Whereas we support the fair-value recognition of investee companies, we recognize that there are exceptions to the general rule. These exceptions, as articulated in our previous comment letter[7], arise under the following circumstances:

- If/when the investment manager[8] guarantees (explicitly or implicitly) the return to shareholders of the investment company, then the shareowners of the investment company no longer bear the predominant risk of the underlying investment. In such cases, consolidation by the investment manager is the appropriate accounting model.
- If/when the investment manager provides financing to the investee, guarantees (implicitly or explicitly) significant liabilities of the investee, or has legal responsibility for the liabilities of the investment company or an investee, then consolidation by the investment manager is the appropriate accounting model.
- If/when the investee has unusually high financial leverage that may suggest an implicit debt guarantee (e.g. due to reputation risk) by the investment manager, this may require consolidation.

Financial Statement Presentation (Box 104)

ESMA's proposed advice in Box 104 outlines the content and format of the balance sheet and income statement. However, we strongly recommend that the presentation requirements of all investment entities including AIFs should be addressed within the scope of IASB's existing standards (i.e. IAS 1 and IAS 7) and the reforms being made therein to these standards under the Financial Statement Presentation project. This is opposed to presentation requirements being addressed at an industry specific level.

As noted earlier, industry-specific reporting reforms which do not have a conceptual rationale for differentiated treatment can end up contributing to reduced comparability in the reporting practices across industries. Besides, the delineation of income statement and balance sheet requirements as described in Box 104 is made at a very high level when compared to the IASB and FASB Financial Statement Presentation previous consultative efforts[9]. For example, it does not exhaustively address the user needs of adequately disaggregated and cohesively presented information. Hence, the attempt to cover one of the most important areas for investors, namely the presentation of statement of financial position, wealth creation and cash flows, is undertaken in a very limited sense. As a result, the proposal does not lend itself to any meaningful evaluation and response of whether it is actually improving current financial reporting of investment entities over what is required under the IFRS framework.

Furthermore, in paragraph 22, ESMA seems to encourage a materiality or country-specific GAAP override in determining whether investment entities ought to present a cash flow statement. This is in contrast to existing and prospective IFRS requirements which always require the issuance of a cash flow statement. This is another situation where the likely

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[7] Ibid.

[8] Investment managers obtain their revenues by charging investment management fees to the funds (investment companies) under their management.

[9] FASB and IASB Discussion Paper, *Preliminary Views on Financial Statement Presentation-Discussion* (April 14, 2009).

outcome will be reduced comparability in reporting practices across different EU national jurisdictions and similar companies, due to the increased discretion and compliance options being granted to reporting entities.

We strongly support the IFRS requirement of cash flow statement presentation in all instances. Regardless of the industry, it is important to provide investors information that distinguishes between cash flow, accruals and valuation changes. The cash flow statement information is needed to allow investors to build an overall picture regarding the veracity of key drivers of value of investee companies. This is the case with respect to dividends being up-streamed from the investee to the investing entity.

The cash flow statement should also be made more informative to investors, by requiring the gross presentation of cash invested during the period. Such a gross presentation helps to inform investors on the portfolio turnover.

Disclosure of key changes and key activities

Through Boxes 101, 103 and 105, ESMA outlines its recommendations for disclosure of key changes in financial statements and key activities. However, similar to the comments on financial statement presentation made above, we recommend that the determination of all key disclosure requirements should be undertaken wholesomely within respective IFRS standards, rather than being addressed in a piecemeal fashion.

VIII. II. Possible Implementing Measures on Disclosures to Investors [Boxes 107-108]

CFA Institute agrees that investors should receive information about each AIF that is marketed within the EU or a member state, and that this information should be provided to investors prior to their initial investment in the fund as well as on an ongoing basis. Investors deserve to receive the information that allows them to make meaningful investment decisions.

In general, we agree with the proposed *periodic* disclosures that AIFMs would be required to provide investors, particularly noting the importance that investors know of any special arrangements and the applicable related management and performance fees. We also believe investors are entitled to receive timely information upon an AIFM's decision to activate side pockets or other similar arrangements, or when it decides to suspend redemptions.

We also generally agree with the proposed approach for providing *regular* disclosures to investors which, in this case, principally focuses on the level of leverage exposure of the AIF as managed by the AIFM. In order to make an informed investment decision, investors should be provided information by which they can understand the appropriateness of the leverage measures or ratios in the context of the AIF's investment strategy. To this end, we support the requirements to provide such disclosures in a timely manner and in a way that is clear and understandable to investors.

Q67: Which option for periodic disclosure of risk profile under Box 107 do you support? Please provide reasons for your view.

With respect to the proposed requirements relating to disclosing the risk profile of each AIF, we favour proposed Option 1. The requirement that the AIFM's disclosures contain an assessment of the exposure of the portfolio to the most relevant risks and a description of remedial measures where risk limits have been exceeded provides a workable framework within which the specific AIFM can operate.

We understand, as noted, that implementing measures must be designed so as to "accommodate a broad range of approaches" in keeping with the type, investment strategy, and asset class of the AIF. We suggest, however, that final regulations also provide a portion of the language in Option 2 as guidance to the AIFM about the types of disclosures it should be making to fulfil its obligations under Option 1. Specifically, we recommend that the periodic disclosures made by an AIFM address "the results of any relevant stress tests, or an indication as to whether, in the opinion of the AIFM, the exposure is likely to increase, is stable or is decreasing and within, near to, or exceeding risk limits set by the AIFM."

Q68: Do you think ESMA should be more specific on how the risk management system should be disclosed to investors? If yes, please provide suggestions.

CFA Institute believes that the disclosure requirements on the risk management systems as proposed by ESMA are appropriate.

Concluding Comments

CFA Institute is pleased to submit its views on ESMA draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive. If you or your staff have questions or seek clarification of our views, please feel free to contact either:

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