



Alternative Investment Management Association

DG Financial Stability, Financial Services and Capital Markets Union
Unit C1 - Capital markets union
European Commission
Rue de Spa 2
1049 Brussels
Belgium

Submitted electronically via http://ec.europa.eu/finance/consultations/2015/financial-regulatory-frameworkreview/index_en.htm

29 January 2016

Dear Sirs,

AIMA submission: Call for Evidence on the EU Regulatory Framework

The Alternative Investment Management Association¹ (AIMA) welcomes the opportunity to respond to the European Commission's Call for Evidence on the EU Regulatory Framework for Financial Services² (the Call for Evidence).

We believe that most of the regulatory measures introduced since the financial crisis have been justified in addressing key policy concerns and market failures. However, a thorough review and evaluation of this new regulatory framework is warranted in order to ensure that the policy objectives are being met and, if not, to adjust the structure where necessary. The speed with which some of the legislation was introduced, the difficulty of coordination between sectoral legislation and geographically, as well as the challenge of assessing the impact of the rules, means that some measures have inevitably led to suboptimal outcomes.

Furthermore, the EU faces the additional challenge of overly relying on the banking sector to finance its economy. Our research shows that economic growth increases with bigger and more liquid capital markets. The link is simple - capital market financing provides more long-term and transparent forms of financing which encourage greater innovation and discipline, leading to better allocation of resources. There are a number of barriers which prevent non-bank finance and capital markets from developing in the EU and we believe that the most immediate opportunity exists in the adjustment of the framework for securitisation. Asset managers are currently heavily constrained in participating on the supply side of the securitisation process and these constraints appear to be unjustified given the high level of regulation and oversight of this sector.

From a financial stability perspective, a move towards financial assets and liabilities being held by institutions and entities capable of bearing risk without the need for public support should be encouraged and not seen as a negative or an unintended consequence of the recent reform process. This move may require a careful rethinking of market structure and infrastructure to support a different model of financial intermediation and investment. Greater involvement of the asset management sector in the direct or indirect financing of the economy is a welcome trend that rests on a sound and recently reinforced foundation which fully addresses micro- as well as macro-

¹ Founded in 1990, the Alternative Investment Management Association (AIMA) has over 1,600 corporate members and over 10,000 individual contacts in over 50 countries. Members include hedge fund managers, fund of hedge funds managers, prime brokers, legal and accounting firms, investors, fund administrators and independent fund directors. AIMA's manager members collectively manage more than \$1.5 trillion in assets.

² See http://ec.europa.eu/finance/consultations/2015/financial-regulatory-frameworkreview/index_en.htm

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prudential concerns. In our submission, we thus address a broad range of themes which are aimed at addressing the above-mentioned views, including the following:

- **Non-bank finance:** Rejuvenating the market for collateralised loan obligations (CLOs), will help finance the recovery and inject greater stability into the system by decreasing SMEs' reliance on banks. We estimate that only 6% of SME finance is currently securitised. If we can increase this percentage, we can increase investment into the sector, giving businesses much needed access to capital markets and increasing the supply of finance to them. Key to this will be facilitating greater participation in securitisation by alternative lenders through collateralised loan obligations.
- **Market liquidity:** Bank capital measures (including leverage limits, the LCR and the NSFR) appear to be constraining dealers' intermediation capacity, which has led to changes in secondary market liquidity in a number of asset classes. This does not mean that banking reforms should be reversed, but does call for careful consideration of how elements of the Basel III package are implemented. Above all, an intelligent approach to market structure and infrastructure regulation that is designed to support secondary market liquidity and enable asset managers to access the market in the most effective way possible should be explored. This is why we welcome a well-thought out implementation of the Markets in Financial Instruments Directive and Regulation (MiFID2/MiFIR) and a review of the European Market Infrastructure Regulation (EMIR).
- **Regulatory reporting:** Increased ongoing compliance costs associated with new rules are arguably most apparent in respect of regulatory reporting requirements, which remain unnecessarily operationally burdensome even once implemented. There is a strong feeling on the part of our membership that regulatory reporting consumes an undue amount of time and resources. While we strongly support the ability for supervisors to obtain the necessary information to fulfil their statutory duties, the content and the manner of reporting could be greatly improved and streamlined so that both reporting and supervision can be carried out more effectively. While changing reporting rules would potentially generate new implementation costs, we believe that these would likely be acceptable when viewed relative to the high ongoing costs associated with regulatory reporting.
- **AIFMD:** The existing AIFMD framework is not yet fully implemented and so a thorough review at this stage would be premature. In particular, we call on the Commission to swiftly finalise the extension of the third-country passport following the receipt of ESMA's advice. Nonetheless, there are some technical adjustments which could be considered in the near term. We would encourage the Commission to investigate the charging of passporting fees and imposition of additional requirements by Member States for the passporting of AIFs under the AIFMD. We set out in Annex 1 why AIMA considers that the national law provisions which seek to impose additional requirements on EU AIFs marketed solely to professional investors in accordance with Article 32 of the AIFMD are at odds with the aims of the single market and the Capital Markets Union. We would also strongly support the introduction of a third measure of leverage as the existing two measures are not suited to sophisticated investment strategies.
- **Short selling regulation:** We provide evidence that public disclosure of short sales under the short-selling regulation (SSR) harms equity market liquidity and believe that it is appropriate at this stage for the European Commission to consider whether a regime of public short-selling disclosures remains appropriate in light of the CMU's objectives. We would urge a further market study to examine the impact of the rules on the market. Regulators should continue to receive reports on short sales.
- **Global consistency of OTC derivatives rules:** We are encouraged that an EMIR equivalence determination in respect of the US framework appears to be imminent, but nevertheless see a need to continue to work towards a more comprehensive solution, especially as regards the EU and US regulatory approaches to equivalence and substituted compliance.



We would be happy to discuss any aspect of this submission with you in further detail.

Yours faithfully,

A handwritten signature in blue ink, appearing to read "J. Król", is positioned above the typed name.

Jiří Król
Deputy CEO
Global Head of Government and Regulatory Affairs
The Alternative Investment Management Association Limited (AIMA)



Annex 1

Rules affecting the ability of the economy to finance itself and grow

- 1) **Unnecessary regulatory constraints on financing:** the Commission launched a consultation in July on the impact of the Capital Requirements Regulation on bank financing of the economy. In addition to the feedback provided to that consultation, please identify undue obstacles to the ability of the wider financial sector to finance the economy, with a particular focus on SME financing, long-term innovation and infrastructure projects and climate finance. Where possible, please provide quantitative estimates to support your assessment.

Example 1: CRR impact on financing

To which Directive(s) and/or Regulation(s) do you refer in your example (if applicable, mention also the articles referred to in your example)?

CRR

Please provide us with an executive/succinct summary of your example

We welcome the European Commission's work to assess the impact of the Capital Requirements Regulation (CRR) on banks' lending activities and likewise encourage the Commission to continue to focus on the way in which future measures stemming from Basel III impact the availability of financing.

Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data, etc.)

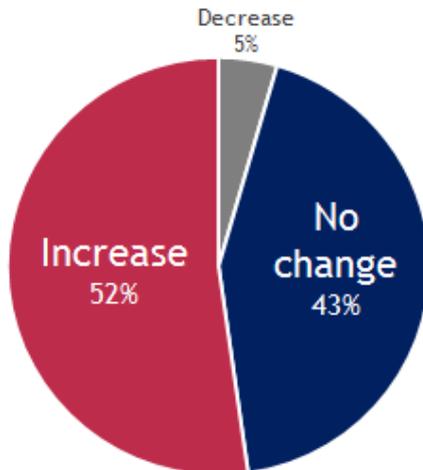
Our members have in the course of the last year become increasingly concerned about the impact of Basel III-related measures on their prime brokerage relationships, leading us to launch a survey in conjunction with S3 Partners, which ran during August and September 2015. 78 hedge fund managers, managing in excess of \$400bn of assets, responded to the survey, the findings of which are presented in the following research report: "Accessing the Financial Power Grid: Hedge fund financing challenges under Basel III and beyond" (<http://www.aima.org/download.cfm/docid/C2FB3D45-5BD8-4133-BB11BB6E401CF7C6>).

Looking back over the previous two years, respondents to the survey were pretty evenly split between those who have already seen an increase in financing costs and those who have not. Looking forward over the coming two years, nearly three-quarters of respondents said that they expect costs to increase further, suggesting that the hedge fund industry has heeded warnings from their prime brokers about the likely impact of Basel III on their business models.

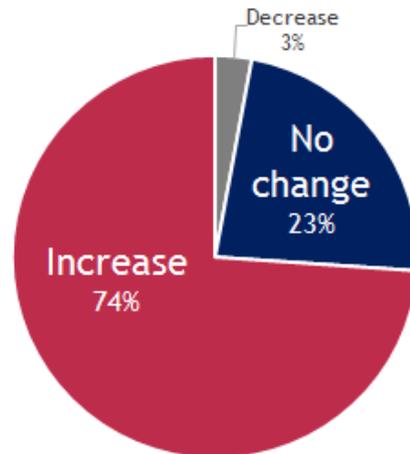


Chart 1

Cost changes in the previous two years



Expected cost changes in the next two years



In terms of the level of cost increases experienced in the past two years, there was a fairly even split between respondents who reported cost increases in the range of 0 - 10% (54%) and those who had seen cost increases in excess of 10% (46%), a material change when considering how broadly this impact is being felt. Certain investment strategies are also more heavily impacted, including those strategies that consume more of dealers' balance sheet (corporate distressed debt, for example). Looking ahead, expectations are that cost increases will be in the range of 0 - 10%, with approximately two-thirds of respondents reporting this as their expectation. Again, this has the potential to translate into a material increase in operating costs for some firms.

We also asked respondents to provide information on whether particular types of financing have become relatively more or less expensive, distinguishing between: repo; margin lending; securities; and synthetic forms of finance. For all of these, with the exception of repo, the majority of respondents suggested that the cost of that specific type of financings had not changed in relative terms. In the case of repo, 59% of respondents who used this type of financing reported that it had become relatively more expensive.

Table 1

Repo, e.g. MRA / GMRA	Relatively more expensive	59%
Margin lending	No change	48%
Securities lending, e.g. MSLA / GMSLA	No change	63%
Synthetic, e.g. ISDA	No change	66%



- 2) **Market liquidity:** please specify whether, and to what extent, the regulatory framework has had any major positive or negative impacts on market liquidity. Please elaborate on the relative significance of such impact in comparison with the impact caused by macroeconomic or other underlying factors.

Example 1: Overarching market liquidity observations

To which Directive(s) and/or Regulation(s) do you refer in your example (if applicable, mention also the articles referred to in your example)?

CRR

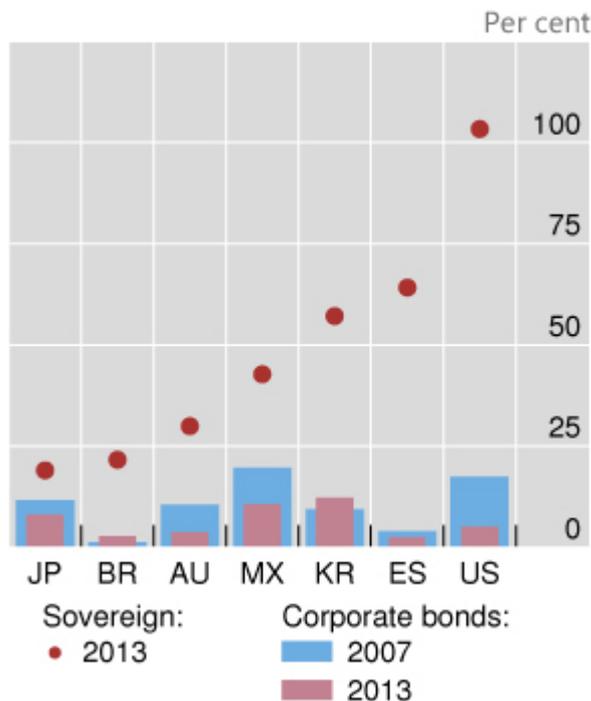
Please provide us with an executive/succinct summary of your example.

As indicated in our response to Question 1, bank capital measures (including leverage limits, LCR and the NSFR) appear to be constraining dealers' intermediation capacity, which has led to a marked fall in secondary market liquidity in a number of asset classes. Analysis by the Bank for International Settlements³ illustrates the particular challenge in corporate bond markets, which have witnessed a decline in liquidity in many jurisdictions.

Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data, etc.)

While this fall off in liquidity might not be immediately apparent from a review of trading volumes, it is more readily apparent when you consider the significant reduction in corporate bond market turnover⁴ between 2007 and 2013.

Chart 2: Corporate bond market liquidity



³ Bank for International Settlements: "Shifting tides - market liquidity and market-making in fixed income instruments" by Ingo Fender and UIF Lewrick, 18 March 2015. See http://www.bis.org/publ/qtrpdf/r_qt1503i.htm

⁴ Turnover ratios are calculated by dividing the monthly aggregate trading volume by the amount of outstanding issues; the BIS chart presents the yearly average of monthly ratios.



The retrenchment of the dealer community from certain secondary markets has a direct impact on others who are active in that space, including asset managers with a focus on government and corporate bonds trading, making execution of their trading strategies more challenging and leading to a concentration of business with a smaller number of banks.

As noted above, prime brokerage relationships have also been directly impacted by changes in the regulation of banks; see: "Accessing the Financial Power Grid: Hedge fund financing challenges under Basel III and beyond" (<http://www.aima.org/download.cfm/docid/C2FB3D45-5BD8-4133-BB11BB6E401CF7C6>). This has resulted in changes to cost and service, posing distinct operating challenges for many hedge fund managers.

If you have suggestions to remedy the issue(s) raised in your example, please make them here.

We acknowledge that in de-risking banking sector activities, measures stemming from Basel III will inevitably constrain the availability of dealers' balance sheets to some degree, making it more challenging for them to intermediate and support market liquidity. Part of the solution, therefore, lies in considering how the rules applying to securities and market infrastructure can themselves be designed in a way that doesn't further constrain banks' capacity to intermediate or alternatively in a way that fosters alternative means for market participants to access liquidity. For example, many of the issues that we address in our overall response to the call for evidence could help to improve the current liquidity situation:

- Streamlining of reporting requirements, as addressed in our response to Question 6, to help lower operating costs for market participants, freeing up additional capacity.
- Ensuring that asset managers are able to trade directly with one another (see our response to Question 13) on FICC trading venues that have historically been dealer-to-dealer systems.
- Supporting moves to repo clearing and adjusting the capital requirements for provision of clearing services to make clearing services less costly, whilst also supporting the move towards self-clearing.
- Avoiding any additional unnecessary measures to address systemic risk, unless warranted by clear evidence.
- Adapting MiFID2 transparency rules, in particular to address the fact that the primary legislation was not drafted in a way that properly accommodates packaged trades.

We also encourage the Commission to ensure that in its implementation of Basel III requirements it ensures that the standards are applied in a way that does not further constrain market functioning. In particular, we are concerned about the following aspects of the regime:

- **NSFR:** We are concerned that the agreed NSFR factors for available stable funding and required stable funding will have a material adverse impact on activities that are central to the effective functioning of financial markets, including stock lending, equity swaps and repo transactions. In turn, financial market liquidity as a whole would be likely to suffer, adversely impact economic recovery and growth. We have argued in a favour a reading of paragraph 45 of the standard that would exclude matched book prime brokerage activities from the standard. Slides illustrating the NSFR's impact are attached with this submission.
- **Leverage ratio:** The leverage ratio, as expressed in the CRR, currently requires EU clearing members of CCPs to count received client margin towards their own exposure, even where that margin is fully segregated from the assets of the clearing member and not available for re-use. Given that the leverage ratio is essentially comprised of a Tier 1 capital numerator and a denominator intended to measure the bank's overall exposures, counting client margin towards a bank's overall exposures results in a considerably less favourable treatment of client cleared derivative transactions. This is



an anomalous result given that segregated margin would generally be seen as protecting against exposure rather than increasing it.

Example 2: Short-selling regulation (SSR)

To which Directive(s) and/or Regulation(s) do you refer in your example (if applicable, mention also the articles referred to in your example)?

SSR

Please provide us with an executive/succinct summary of your example

The SSR obligation to publish significant net short positions has led many of our members to adjust their trading behaviour to stay below relevant publication thresholds. They are concerned that, upon passing these publication thresholds, access to relevant corporate issuers may be terminated as 'pay-back' for shorting their stock, as well the threat of rival market participants being able to reverse engineer their trading positions to trade against them.

Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data, etc.)

Some firms have developed new sign-off procedures for disclosable short positions, whereas others have stopped trading certain instruments entirely or have allocated capital to instruments outside of Europe.

This trend is ultimately likely to have detracted from the liquidity, thus efficiency, of European capital markets and we believe that it is appropriate at this stage for the European Commission to consider whether a regime of public short-selling disclosures is appropriate in light of the CMU's objectives. We would urge a further market study to examine the impact of the rules on the market.⁵ Regulators should continue to receive reports on short sales.

Similarly, for sovereign CDS, liquidity in the market has fallen markedly since the introduction of the SSR prohibition on uncovered sovereign CDS positions, which has in-turn constrained the ability of market participants to use these instruments for hedging risks. This has been the case, in particular, for participants that do not have a static positions in the bonds of that sovereign issuer. It is hard to say with certainty what impact this has had on the underlying sovereign debt market, not least because of the stimulating effects of European Central Bank (ECB) monetary intervention that coincided with the introduction of the SSR regime. Notwithstanding, several of our members have indicated that they have stopped trading EU sovereign CSD and bonds given both the regulatory and reputational risks involved. We consider that restrictions on CDS positions over the medium term will make it more difficult for sovereign issuers to borrow through long-dated securities, leading to a shortening of the average maturity profile of sovereign issued debt and leaving sovereigns exposed to short term liquidity and funding crises. We consider that they full extent upon the impact on liquidity may not become apparent until the next round of significant market turbulence arises and the liquidity foundations of the sovereign debt market are truly tested.

We would suggest that the ban on uncovered sovereign CDS has also had a knock-on impact on the liquidity of small and mid-size corporate issues for which sovereign CDS of the relevant Member State are used as a 'proxy hedge' due to the non-existent or illiquid market in hedging instruments referenced directly to that issuer.

See also:

- AIMA/MFA Response to the Call for Evidence by the European Securities and Markets Authority (ESMA) regarding the evaluation of the Regulation (EU) 236/2012 of the

⁵ See <http://www.oliverwyman.com/insights/publications/2010/feb/the-effects-of-short-selling-public-disclosure-regimes-on-equity.html#.Vo41EPmLTcs>



European Parliament and of the Council on short selling and certain aspects of credit default swaps
<https://www.esma.europa.eu/file/11046/download?token=fpTiM-sf>

- The Effects of Short-Selling Public Disclosure Regimes on Equity Markets, Oliver Wyman
[Http://www.oliverwyman.com/insights/publications/2010/feb/the-effects-of-short-selling-public-disclosure-regimes-on-equity.html#.Vo41EPmLTcs](http://www.oliverwyman.com/insights/publications/2010/feb/the-effects-of-short-selling-public-disclosure-regimes-on-equity.html#.Vo41EPmLTcs)

If you have suggestions to remedy the issue(s) raised in your example, please make them here

We believe that it is appropriate at this stage for the European Commission to consider whether a regime of public short-selling disclosures remains appropriate in light of the CMU's objectives. We would urge a further market study to examine the impact of the rules on the market.

Example 3: Financial transactions tax (FTT)

To which Directive(s) and/or Regulation(s) do you refer in your example (if applicable, mention also the articles referred to in your example)?

FTT

Please provide us with an executive/succinct summary of your example

Whilst we appreciate that the focus of the Call for Evidence is measures that have already been put in place, we believe that it also makes sense to consider those policy measures that are still being discussed.

We consider that the one of the greatest impediments to the CMU would be a financial transaction tax. An FTT will tend to increase the cost of capital and depress liquidity in the secondary market. This impact will be exacerbated if the FTT is capable of being charged multiple times on the stages making up a financial transaction (the cascade effect) or if it is applied to interests in collective investment schemes which function as providers of capital and liquidity (lack of tax neutrality). For instance, if the purchase and sale of units or shares in investments funds is subject to FTT this could increase the costs to investors of investing in investment funds and also adversely impact on the return which investors derive from their investment.

Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data, etc.)

One of the stated goals of the transactions tax, in addition to raising revenue, is understood to be the contribution to greater financial market stability by curbing what are deemed to be excessively speculative trading techniques. However, indications suggest that, depending on how an FTT is calibrated, it may have significant effects on market liquidity. A tax on financial transactions may actually increase volatility and increase financial markets unpredictability. Despite the intention to raise revenue and reduce risk in financial markets, it is not clear from available evidence as to whether these objectives will be achieved. In fact, nearly all assessments suggest that the impact on the Member States' GDP would be negative.⁶

Further, transactions will tend to involve parties and intermediaries not located in FTT jurisdictions, which will render the single market imperfect as well as less competitive than capital markets outside the EU. Even if FTT is implemented across the 28 EU MS, its introduction would be detrimental for EU financial markets. It would lower returns on investments and savings, increase distortion on the market and encourage entities to relocate their financial

⁶ Financial transaction tax: the impacts and arguments. (PWC 2013).



activities outside the EU. Therefore, an FTT would not only add more complexity in economy's financing but also unintended consequences on investors.

If you have suggestions to remedy the issue(s) raised in your example, please make them here

We encourage the European Commission to reconsider the appropriateness of the FTT proposals in light of the CMU's objectives.

- 3) **Investor and consumer protection:** please specify whether, and to what extent, the regulatory framework has had any major positive or negative impacts on investor and consumer protection and confidence.

In our response to Question 9, we explore the particular challenges that exist in respect of the interaction between EU and US rules for OTC derivatives markets. It is worth noting that one of the more extreme consequences of regulatory overlap can be the decision by particular market participants to withdraw from certain activities to ensure that they do not breach one set of overlapping requirements.

- 4) **Proportionality / preserving diversity in the EU financial sector:** are EU rules adequately suited to the diversity of financial institutions in the EU? Are these rules adapted to the emergence of new business models and the participation of non-financial actors in the market place? Is further adaptation needed and justified from a risk perspective? If so, which, and how?

Example 1: Securitisation and non-bank finance

To which Directive(s) and/or Regulation(s) do you refer in your example (if applicable, mention also the articles referred to in your example)?

Securitisation Regulation, AIFMD, ELTIF

Please provide us with an executive/succinct summary of your example

AIMA welcomes President Juncker's vision set out in his Commissioner's mandate "to develop alternatives to our companies' dependence on bank funding" and to seek "appropriate ways to revive sustainable and high quality securitisation markets",⁷ as well as calls from the CMU Action Plan, to look at a more harmonized approach to loan origination.⁸

Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data, etc.)

Bank loans currently represent 80% of Europe's corporate debt and it was this dependence that created the conditions for credit crunch and hampered subsequent growth.

Investment funds already provide loans to EU corporates, many of them serving Europe's fastest growing businesses. Indeed 82% of AIMA members recently surveyed are lending to SMEs.⁹ This activity is only like to expand. We estimate that, within 5 years, somewhere between 15% and 20% of corporate funding could come from such loan and private debt funds¹⁰.

SMEs are particularly deserving of support, as they are responsible for 99 out of every 100, businesses, two in every three employees and 58 cents of every Euro of value added of the business sector.¹¹ We need greater diversity in the supply of finance to support them.

⁷ [Mission letter to Commissioner Jonathan Hill from President Juncker 1 November 2014.](#)

⁸ http://ec.europa.eu/finance/capital-markets-union/docs/building-cmu-action-plan_en.pdf

⁹ <http://www.aima.org/en/document-summary/index.cfm/docid/A509C9FF-F7C5-4772-9148D8A687B1573C>.

¹⁰ *Ibid.*

¹¹ Commission report, [A Partial and Fragile Recovery—Annual Report on European SMEs 2013/2014](#).



The first step we would recommend to the European Commission is to ensure that the ELTIF regulation is swiftly and correctly implemented in all Member States, ensuring that ELTIFs can originate and manage loans to small businesses without any barriers imposed by member states. Before this has been addressed, it will become difficult to see how any additional legislation in this space could achieve the desired policy outcome.

In a second stage, one could make the ELTIF framework more attractive to both loan fund managers and professional investors. Given that many of the restrictions in the ELTIF regulation are aimed at protecting retail investors, there is merit in exploring the possibility of 'professional investor only' ELTIF. This would allow professional investors such as insurance companies to benefit from the lower capital requirements imposed on ELTIFs, without restricting the managers' freedom of action and without the additional cost of protections designed for less sophisticated investors.

Professional investors usually have access to the type of advice which will enable them to take a properly informed decision as to the types of risks inherent in illiquid assets and the overall allocation of their portfolio they should make to ELTIFs, using appropriate risk and liability management tools. Provided an ELTIF is limited to professional investors we expect that the lack of liquidity in the underlying assets would be well understood and professional investors would be prepared to gain exposure to these asset types through a closed-ended vehicle. However, in order for the product to be attractive to these types of investors, we would suggest that a number of the proposed investment restrictions aimed at retail investors also be removed, in particular on eligible assets and diversification, hedging risk and prospectus requirements.

The opportunity for SME lending is greater still, if we consider that the entities that manage those funds were able to easily securitise those loans and offer them to institutional investors as collateralised loan obligations (CLOs). This could further free up the lending capacity of these alternative providers of finance - creating a significant, sustainable and fully regulated chain of non-bank finance.

Rejuvenating the securitisation market, in particular for CLOs, will help finance the recovery and inject greater stability in the system by decreasing their reliance on banks. We estimate only 6% of SME finance is currently securitised. If we can increase this percentage, we can increase investment into the sector, giving businesses much needed access to capital markets and increasing the supply of finance to them. A key to this will be facilitating greater participation in securitisation by alternative lenders through CLOs.

CLOs differ from most other securitization structures backed by term loans in that the portfolio of loans is actively managed by the CLO manager. Even after the CLO closing, the CLO manager continues to make investment decisions over a specified reinvestment period during which proceeds from sold, maturing, or refinanced loans are reinvested. That said, there are strict contractual requirements that limit the discretion of the CLO manager.

CLOs, managed by investment funds, represent a huge opportunity to increase the supply of credit to the European businesses in a responsible way. This is particularly so for SMEs. Indeed if we can increase the percentage of SME loan securitisation back to its pre-crisis peak of 9.3%, and in parallel increase the participation of alternative lenders in the market, we can significantly increase the stock of SME finance in the EU.¹²

Financing SMEs through investment fund-led CLOs also fosters greater financial stability. According to the International Monetary Fund (IMF), 95% of SME securitisations are retained by credit institutions.¹³ Many of these were held in SPVs that were money market funded and subject to run risk. In the case of a CLO, securities would be sold to long-term investors whose time horizon typically aligns with the maturity of the loans. This means they are definitively off bank balance sheets freeing them up to focus on new lending.

¹² Based on internal AIMA estimates, by €89bn, without factoring in additional EU support schemes.

¹³ Revitalising Securitisation for SMEs in Europe, IMF Discussion Note, 2015.



If you have suggestions to remedy the issue(s) raised in your example, please make them here

If we are to realise the opportunities described above, the Securitisation Regulation should be adjusted as compliance with the proposed rules will be difficult for CLOs. In particular, the definition of sponsor is ill-suited to common CLO market practice and fund structures and the retention requirements, while not without merit, will be therefore rendered difficult to meet.

Second, although AIMA members welcome the benefit Europe's consumers will receive from lowered risk weights of securitised consumer lending instruments, the exclusion of all actively managed CLOs from STS, which may cut financing lines to companies employing Europe's consumers, should be revisited. Active management can be subject to strict criteria which deliver the same, if not better, result as static securitisations. We believe that if such criteria, which form the current market practice today, could be made binding for those actively managed CLOs wishing to avail themselves of the STS designation.

Lastly, it is important that improvements to the regime for European securitisation do not impinge on other economic activity through unintended consequences. A key example is the possible inclusion of Non-Performing Loan (NPL) portfolios within the CRR definition of the term "securitisation". The CRR, in Article 4(61) uses 'tranching' to differentiate transactions as securitisations. As a result, because of the characteristics involved in the sale of an NPL portfolio, by the letter if not the spirit of the CRR, such activity would be deemed as securitisation. The financing of such loans typically involves an SPV, financed by senior bank debt, and equity that typically takes the form of subordinated debt. Thus the financing arrangements have technically been 'tranching' and could be considered securitisations.

On close inspection, none of the parties involved in NPL portfolio sales fit with the definitions used for parties in securitisation, notably sponsor/originator. Thus complex and synthetic structures would need to be devised to ensure compliance. This could deter potential investors in NPLs, prevent banks from improving their balance sheets and stymie the growth of the underlying businesses. The CRR should therefore make it clear that simple NPL sales should not be considered as securitisations and taken out of scope.

This is just one example of the too broad scope of the definition of the term "securitization" and we would urge the Commission to consider revisiting the scope of this definition generally.

Example 2: Prudential treatment of alternative investments

To which Directive(s) and/or Regulation(s) do you refer in your example (if applicable, mention also the articles referred to in your example)?

AIFMD, CRD IV

Please provide us with an executive/succinct summary of your example

AIMA members welcome the CMU's commitment to diversifying the available sources of funding for European businesses, to foster sustainable economic growth and increase the resilience of our financial system. As we develop new lending channels, particularly outside of the banking system, we need to make sure that they are appropriately regulated, but only according to the underlying economic activity they conduct.

Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data, etc.)

As a result of the recent financial crisis, banks have been encouraged to deleverage their balance sheets and increase their capital. This has put pressure on the amounts of funding that banks are able and willing to lend. Consequently, there has been a dearth of available financing for business for long-term as well as short-term projects. Today, a number of jurisdictions permit AIFs to originate and manage loans, helping to channel finance to where it is needed.



This is done under a very tight investor protection and prudential framework. The AIFMD requires AIFMs to manage and monitor their liquidity, to provide extensive disclosures to both investors and regulators (in particular, in relation to the use of leverage) and to implement adequate risk management systems in order to identify, measure, manage and monitor appropriately all risks relevant to each AIF investment strategy and to which each AIF is or may be exposed. We consider that the regulatory framework set out in the AIFMD is therefore already adequate and that further regulatory measures should not be necessary to mitigate any shadow banking concerns which may be raised by AIFs originating loans.

We therefore disagree with the European Banking Authority's December 2015 paper 'Guidelines on limits on exposures to shadow banking', which stated that funds that make loans are shadow banks, along with any leveraged AIFs, and as such a bank would have to hold more capital against these exposures. This ignores the fund structures deployed in such entities, as well as the regulation on leverage that already applies under AIFMD. If these precedents go unchecked into non-bank regulation, it will make it very difficult to foster the alternative channels Europe needs.

If you have suggestions to remedy the issue(s) raised in your example, please make them here

The Commission should set out clearly that it will not expect regulators to use the EBA's designation of 'shadow banks' when considering regulatory treatment of non-bank finance, whether it is loan funds, investment fund CLOs or hedge funds. All are subject to adequate prudential regulation under existing directives, tailored to them, and should not be swept up into regulation meant for banks.

Unnecessary regulatory burdens

- 5) **Excessive compliance costs and complexity:** in response to some of the practices seen in the run-up to the crisis, EU rules have necessarily become more prescriptive. This will help to ensure that firms are held to account, but it can also increase costs and complexity, and weaken a sense of individual responsibility. Please identify and justify such burdens that, in your view, do not meet the objectives set out above efficiently and effectively. Please provide quantitative estimates to support your assessment and distinguish between direct and indirect impacts, and between one-off and recurring costs. Please identify areas where they could be simplified, to achieve more efficiently the intended regulatory objective.

Example 1: Ongoing compliance burden

To which Directive(s) and/or Regulation(s) do you refer in your example (if applicable, mention also the articles referred to in your example)?

EMIR, AIFMD, MiFID

Please provide us with an executive/succinct summary of your example

It is undoubtedly true that rules have become more prescriptive, which generates increased compliance costs for participants in the financial services industry. This is arguably most apparent in respect of reporting requirements, which remain operationally burdensome even once implemented.

Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data, etc.)

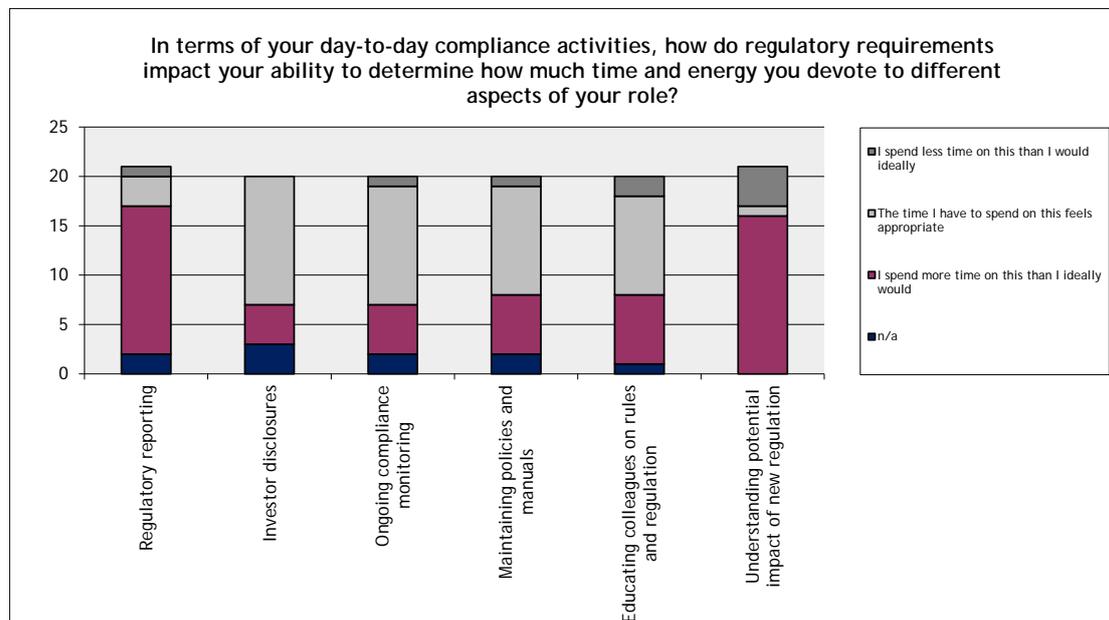
In a poll of 20 AIMA committee members, we asked them to assess whether they feel that regulatory requirements lead them to spend too much time on any particular aspects of their role. Chart 3 below presents the responses to this question, illustrating the strong feeling on the part of our membership that regulatory reporting consumes an undue amount of their time - at the expense of other activities including compliance monitoring.



While changing reporting rules would potentially generate new implementation costs, we believe that these would likely be acceptable when viewed relative to the high ongoing costs associated with regulatory reporting. The review of the European Market Infrastructure Regulation (EMIR) provides a good illustration of this point. Some in the regulatory community have noted that a rework of the EMIR reporting structure to deliver industry’s preferred single-sided reporting model would lead to additional costs associated with redesigning reporting systems, which would negate the value of moving away from dual-sided reporting. From discussions with our members, it is clear, however, that such one-off costs would be acceptable given that they would ultimately lead to a reduction in the significant ongoing cost of fulfilling EMIR reporting requirements. The point is relevant more broadly when it comes to a consideration of reporting, a topic to which we return in our response to question 6.

We also note that a key challenge for our members is not just the complexity of individual pieces of legislation, but the fact that the EU’s approach to policymaking in the period after the financial crisis has entailed multiple pieces of legislation being reworked at the same time, with little regard to the lead-in time for new pieces of legislation or the overall coherence of rules developed for different products or sectors. From the point of view of those responsible within firms for monitoring regulatory developments, this has significantly increased the amount of time that they spend on seeking to understand the impact of new rules and regulation, as illustrated by Chart 3.

Chart 3: A snapshot of a compliance officer’s role



If you have suggestions to remedy the issue(s) raised in your example, please make them here

We believe that more consideration should in future be given to the scale of future regulatory proposals, to ensure that they can be implemented in a manageable way. We also believe that more attention should be given to the time available for the Level 2 process.

AIMA considers that a significant obstacle facing the ESAs in terms of meeting their respective mandates is the length of time granted by legislators to the ESAs for Level 2 consultations to be undertaken and technical standards or technical advice drafted. Many previous Level 1 texts - including the Alternative Investment Fund Managers Directive (AIFMD), EMIR and, in particular, SSR - have provided extremely short timeframes for the European Securities and Markets Authority (ESMA) to draft Level 2 measures. This can be exacerbated further, for example, when technical standards are rejected very close to the absolute implementation date - as occurred when ESMA’s regulatory technical standards on determining types of alternative investment fund managers (AIFM) under the AIFMD were rejected on 4 July 2013 and new standards requested by 22 July 2013, thus providing only 18 days within which to consult and turn new standards. We consider that such demands and potential last minute changes can, and have on occasion, jeopardized the



goal of drafting technical regulation which is sufficiently comprehensive, legally certain and practically sustainable.

Cost benefit analysis as mandated under the ESA Regulations is especially difficult in such short timeframes. It is vital for both the ESA and industry participants that the ESA is granted sufficient time to enable proposals to be fully considered and for all alternative options to be identified so as to ensure a robust and thorough Level 2 process. In this regard, provision must be made to ensure that any Level 1 texts do not unduly constrain the length of time available for Level 2 work. In particular, we believe that problems with regard to timing are far more likely to be experienced when a specific date for Level 2 measures is mandated within the Level 1 text than when a specific length of time after entry into force is granted.

Similarly, we recognise that many legislative initiatives are subject to indicative international deadlines - for example, the December 2012 deadline for mandatory clearing and reporting of over-the-counter (OTC) derivatives. Such international deadlines, however, are arguably designed to be indicative and encourage implementation, rather than to set a hard date. This is especially the case bearing in mind that such deadlines are set before any of the technical and political issues which lead to delays become apparent. It is understandable that legislators and regulators may wish to complete their work within these high-level deadlines, however, should this result in unreasonable time constraints for completion of Level 2 work, such time pressure is undesirable and could potentially prove counterproductive to the relevant international legislative goal. AIMA therefore recommends that adequate time be granted for Level 2 work in furtherance of internationally mandated legislation to ensure that technical recommendations are optimally formulated, rather than rushed through.

Once the substantive Level 2 work is completed, harmonised national implementation is also very important. In this regard, AIMA recommends that a phased implementation timetable be provided by the Commission which, at all times, makes clear to market participants that the Level 1 provisions which are subject to elaboration/implementation via the Level 2 measures do not have direct effect until the latter measures are adopted and implemented. This is particularly important for measures which are imposed through the format of a directly applicable European Regulation. Such allowances have been seen in EMIR.

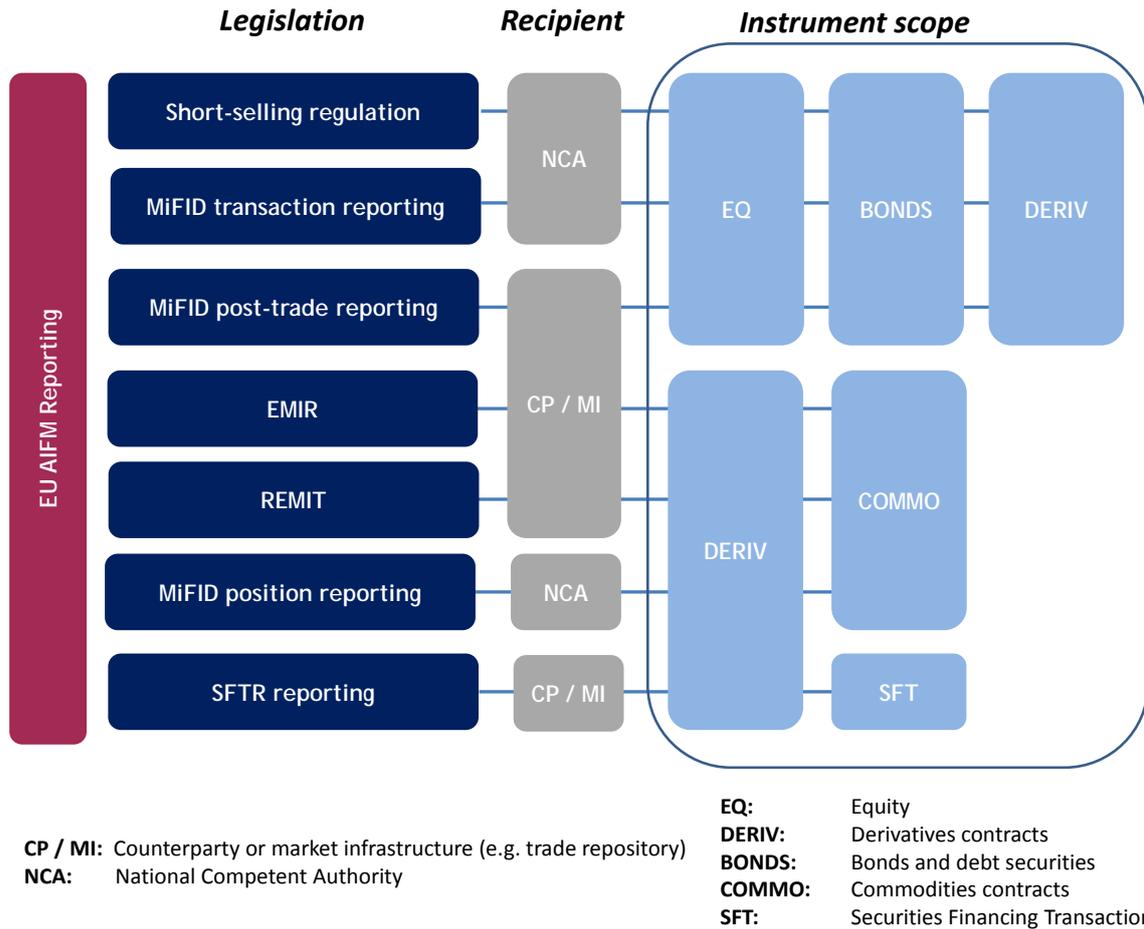
AIMA believes that the above principles relating to sufficient time should also be applied for the development of Level 3 measures, including ESMA Guidelines and Question and Answer documents. Such documents impact upon the interpretation, and, therefore, legal certainty, of central Level 1 and Level 2 provisions. Sufficient time, accordingly, is vital to ensure appropriate conclusions are reached by the relevant ESA drafting the measures.

- 6) **Reporting and disclosure obligations:** the EU has put in place a range of rules designed to increase transparency and provide more information to regulators, investors and the public in general. The information contained in these requirements is necessary to improve oversight and confidence and will ultimately improve the functioning of markets. In some areas, however, the same or similar information may be required to be reported more than once, or requirements may result in information reported in a way which is not useful to provide effective oversight or added value for investors. Please identify the reporting provisions, either publicly or to supervisory authorities, which in your view either do not meet sufficiently the objectives above or where streamlining/clarifying the obligations would improve quality, effectiveness and coherence. If applicable, please provide specific proposals. Specifically for investors and competent authorities, please provide an assessment whether the current reporting and disclosure obligations are fit for the purpose of public oversight and ensuring transparency. If applicable, please provide specific examples of missing reporting or disclosure obligations or existing obligations without clear added value.

As noted above in our response to question 5, regulatory reporting has become a significant burden for the hedge fund industry, something that will become even more acute as the Regulation on Reporting and Transparency of Securities Financing Transactions (SFTR) and recast Markets in Financial Instruments Directive (MiFID2) are implemented. Figure 1 illustrates the vast range of different requirements that are likely to be applicable to EU alternative investment fund manager in the future.



Figure 1



There are a number of ways in which the Commission could work to improve this situation, as explored below.

Example 1: EMIR

To which Directive(s) and/or Regulation(s) do you refer in your example (if applicable, mention also the articles referred to in your example)?

EMIR

Please provide us with an executive/succinct summary of your example

Implementation of the two-sided reporting obligation contained within Article 9 of EMIR has proved enormously challenging for industry participants, with a range of operational issues experienced by AIMA's hedge fund members:

- **Bottlenecks:** At the outset of the obligation, many of our members experienced difficulties onboarding with trade repositories due to the sheer numbers of participants also seeking to register, leading to bottlenecks whereby trade repository systems could not manage the volume of applications.
- **Unfavourable terms of delegation:** The requirement for both counterparties to a transaction to report introduces the need for all counterparties without internal reporting capabilities to enter into AIMA Response to Commission Public Consultation on the EMIR Review 5 delegation agreements with third parties to report on their behalf. It has been widely experienced that the terms of these delegation agreements with dealers - for smaller entities in particular - have not been favourable. Particular issues have included



that, once information has been reported to a trade repository on the fund's behalf, the fund still has the obligation to access and reconcile the information, which has proved extremely difficult in practice.

- **Duplication of infrastructure:** Unattractive terms of delegation have led many of our larger manager members (that are able to do so), to report on their own behalf, thus duplicating operational costs for derivatives trading across both counterparties to the transaction.

AIMA would consider these costs as proportionate if they led to a commensurate improvement in the quality of supervisory data available to EU regulators to monitor systemic risk build-up. However, significant issues have been experienced around the matching of corresponding reports relating to the same transaction, with very low matching rates, meaning that dual reports have not improved and perhaps have reduced the quality of supervisory data available to EU regulators.

AIMA recognises that all new regulatory obligations have initial issues that need to be ironed out and appreciates the regulatory reasoning behind the introduction of two-sided reporting to facilitate improved data quality and regulatory oversight. However, we believe that practical experience has demonstrated that the two-sided reporting structure does not work effectively; this can be demonstrated by the fact that even eighteen months after the entry into effect of the EMIR reporting obligation, significant issues still exist in the matching of reports by trade repositories.

Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data, etc.)

- See: "The Cost of Compliance: Global hedge fund survey by AIMA, MFA and KPMG", 2013
<http://www.aima.org/download.cfm/docid/1ED2D8EA-F096-4765-88DDAA8F60392512>

If you have suggestions to remedy the issue(s) raised in your example, please make them here

We would recommend that EMIR be amended to provide for a single-sided reporting mechanism. AIMA considers that a well-formulated single sided reporting mechanism with a clear hierarchy of reporting responsibilities for different classes of counterparty (including 'tie-break' rules for situations involving two counterparties of the same class) and a related requirement to ensure the accuracy of data utilising the existing confirmations and reconciliations framework under EMIR, would be preferable from the perspective of both buy and sell-side industry participants, and supervisors.

We consider that a single-sided reporting mechanism would represent a far more efficient use of resources for counterparties and regulators. Not least because the significant human and technological resources needed to reconcile two-sided reports could instead be spent on analysing the reported data for signs of systemic risk buildup. We also note that single-sided reporting would solve the abovementioned issues experienced by buy-side participants, by avoiding the need to enter into delegation agreements and/or duplicate their counterparties' reporting infrastructures in the first place. Even under the single-sided reporting mechanism we propose, there is still a degree of operational and data duplication for cleared client trades - with both the CM and CCP required to submit separate reports for each leg of the trade. As part of the EMIR review it could be useful to consider whether this structure can be further streamlined to reduce the number of duplicate reports that are filed.

It is true that initial costs have been sunk into the implementation of dual-sided reporting which would have to be written-off and additional costs to build the system would need to be incurred. AIMA also recognises current regulatory concerns that moving to single-sided reporting could make it harder to identify shortcomings in the data (assuming that dual-sided reporting starts to work in the future) as there will not be a corresponding mirrored report from the other counterparty. Nonetheless, we believe that that a well-formulated single-sided reporting requirement, accompanied by appropriate sanctions for breaching requirements, would be the most efficient approach in the long term - obtaining the relevant information for regulatory supervisions in the most proportionate way.



Example 2: Short-selling regulation

To which Directive(s) and/or Regulation(s) do you refer in your example (if applicable, mention also the articles referred to in your example)?

SSR

Please provide us with an executive/succinct summary of your example

Our membership strongly believes that the SSR's reporting mechanisms are operating inefficiently and create significant (and unnecessary) operational difficulties. Our members' principal concern is the disparate range of communication methods and notification formats adopted by competent authorities. Each authority has implemented an approach, which, to a varying extent, is unique. This creates confusion and is likely to detract from the quality of data received by competent authorities; seen in light of reporting requirements under other pieces of legislation, the overall impact is significant. This unsatisfactory approach could be readily resolved by implementing a single pan-European approach for collection of SSR notifications.

Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data, etc.)

- AIMA/MFA Response to the Call for Evidence by the European Securities and Markets Authority (ESMA) regarding the evaluation of the Regulation (EU) 236/2012 of the European Parliament and of the Council on short selling and certain aspects of credit default swaps
<https://www.esma.europa.eu/file/11046/download?token=fpTiM-sf>

If you have suggestions to remedy the issue(s) raised in your example, please make them here

We encourage the Commission to remove the barriers to an efficient SSR reporting mechanism by working with the competent authorities and ESMA to establish a single reporting platform for all net short position disclosures (for onward distribution to the relevant competent authority). This could be readily accomplished through the establishment of a single website for pan-European notifications, allowing, for example, single-batch uploading of notifications using one file format. This would also significantly reduce the costs and operational burden associated with the high frequency of notifications required by the current threshold levels.

Should the Commission be unable to achieve this pan-European system, we suggest, as an alternative, that a standard form and communication method be implemented by competent authorities. We recommend that ESMA create a single standard notification form in Excel format (with a specified cell in which to provide identification details, logo, contact details etc. to be used by each of those authorities. We also suggest that ESMA should agree with these authorities on a single straightforward communication method (e.g. an e-mailed Excel form). This will permit our members to develop more automated solutions to the form completion and dispatch processes than are currently possible given the existing diversity of forms and communications methods.

Example 3: AIFMD Annex IV reporting

To which Directive(s) and/or Regulation(s) do you refer in your example (if applicable, mention also the articles referred to in your example)?

AIFMD

Please provide us with an executive/succinct summary of your example

Implementation of the reporting requirements of the AIFMD, in particular those set out in Annex IV of the Level 2 Regulation¹⁴ (Annex IV reporting), has proved extremely challenging for our

¹⁴ Regulation EU (No) 231/2013.



manager members. Annex IV reporting requires managers to compile large quantities of data from a number of sources and to perform complex calculations. This has cost all AIFMs who manage an EU alternative investment fund (AIF) or market an AIF in the EU a great amount of time and money with no visible benefits for investors, regulators or the industry.

Member State's interpretations of certain requirements or the format in which managers are required to report have varied. It is also unclear to the industry what is being done with the data and how competent authorities are using it. We would welcome greater transparency being given to AIFMs as to what is being done with the data in the reports that they are taking considerable time and effort to complete. For example, we would welcome more communication from the national competent authorities as to how data is being interpreted and more guidance on what the national competent authorities expect to see in the reports as well as the observations that they are making as a result of the data. It may also be helpful to see public reports of aggregate data, such as the hedge fund manager survey which used to be produced by the UK Financial Conduct Authority (FCA).

Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data, etc.)

- See: The cost of compliance - Survey by AIMA, MFA, KPMG - October 2013
<http://www.aima.org/download.cfm/docid/1ED2D8EA-F096-4765-88DDAA8F60392512>

If you have suggestions to remedy the issue(s) raised in your example, please make them here

We consider that in order for data compiled as a result of the AIFMD to be able to give competent authorities an indication of the systemic importance of an AIFM/AIF, that there needs to be consistent interpretations of data required and received, as well as supervisory cooperation and coordination. We welcome ESMA's efforts to give guidance on the Annex IV reporting requirements, but consider that in order to improve Annex IV reporting, ESMA should produce a more comprehensive common reporting methodology, instructions and interpretations.

We would also welcome ESMA (or another designated body) acting as the single portal for receipt of Annex IV reports. This would ensure that managers operating under the Article 42 national private placement regimes would not be required to file different reports in each Member State in which they market. It would also ensure that data is submitted in one uniform format and so it will be simpler to compare reports from AIFMs/AIFs which are required to report in different home Member States. Whilst we consider that common supervision is not a good objective and that it should be left to national competent authorities to supervise their local AIFMs, we consider that common data reporting is a good and proportionate objective.

Example 4: MiFID2 transaction reporting

To which Directive(s) and/or Regulation(s) do you refer in your example (if applicable, mention also the articles referred to in your example)?

MiFID

Please provide us with an executive/succinct summary of your example

We note that implementation of MiFID2 transaction reporting requirements is an issue of concern for the regulatory community and participants from across the financial services industry, reflecting both the broad scope of the obligation and the level of detail of what will have to be reported when MiFID2 rules come into application.

Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data, etc.)

If you have suggestions to remedy the issue(s) raised in your example, please make them here



The impact of the new rules could be greatly lessened if clients were able to rely on their brokers to report for them. The concept of transmission under MiFID2 was arguably intended to promote this outcome, by making a broker responsible for reporting in a situation where a client merely transmits the order to the broker. However, from initial implementation discussions, it has become clear that the ability of the buy-side to rely on this provision is limited, given the volume of information that would need to be passed on to the receiving party and the need for a written agreement regarding the transmission relationship.

- 7) **Contractual documentation:** standardised documentation is often necessary to ensure that market participants are subject to the same set of rules throughout the EU in order to facilitate the cross-border provision of services and ensure free movement of capital. When rules change, clients and counterparties are often faced with new contractual documentation. This may add costs and might not always provide greater customer/ investor protection. Please identify specific situations where contractual or regulatory documents need to be updated with unnecessary frequency or are required to contain information that does not adequately meet the objectives above. Please indicate where digitalisation and digital standards could help to simplify and make contractual documentation less costly, and, if applicable, identify any obstacles to this happening.
- 8) **Rules outdated due to technological change:** please specify where the effectiveness of rules could be enhanced to respond to increasingly online-based services and the development of financial technology solutions for the financial services sector.

Example 1: UCITS

To which Directive(s) and/or Regulation(s) do you refer in your example (if applicable, mention also the articles referred to in your example)?

UCITS

Please provide us with an executive/succinct summary of your example

When the UCITS Directive was originally introduced in 1985, Article 45 provided that a UCITS which markets its units in another Member State:

“must, inter alia, in accordance with the laws, regulations and administrative provisions in force in the Member State of marketing, take the measures necessary to ensure that facilities are available in that State for making payments to unit-holders, re-purchasing or redeeming units and making available the information which UCITS are obliged to provide.”

This provision has survived the various revisions to the UCITS Directive and is now set out in Article 92 of the UCITS IV Directive (Directive 2009/65/EC)¹⁵, meaning that any UCITS marketed on a cross-border basis is obliged to comply with varying laws in host Member States regarding the appointment of a paying agent.¹⁶ Whilst there may have been good reason in 1985 to require that there be local paying agent in place in Member States where a UCITS is marketed, it is hard to understand the justification for the appointment of a paying agent 30 years later given the technological advances that have been made. The functions carried out by the paying agent can now easily be met by either the UCITS management company or its existing service providers without the need to have a physical presence in each Member State. For example, one function often carried out by a local paying agent is for them to make documents and information available to investors and to deal with requests for information from investors. This function can now be fulfilled by the UCITS management company, which will in any event be obliged to keep documents such as its prospectus on its website. Furthermore, investors will be able to, and will most likely

¹⁵ Article 92 states that: “UCITS shall, in accordance with the laws, regulations and administrative provisions in force in the Member State where their units are marketed, take the measures necessary to ensure that facilities are available in that Member State for making payments to unit-holders, repurchasing or redeeming units and making available the information which UCITS are required to provide.”

¹⁶ In some Member States this is referred to as a centralising agent or a facilities agent, but we use the term ‘paying agent’ here to mean an entity which makes facilities in the host State available for making payments to unit-holders, re-purchasing or redeeming units and for making available the information which UCITS are obliged to provide.



wish to, contact the UCITS management company directly with any requests for information and documents.

Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data, etc.)

If you have suggestions to remedy the issue(s) raised in your example, please make them here

So long as the functions carried out by the paying agent are carried out by either the UCITS management company or its existing service providers, we therefore consider that where a UCITS is marketed on a cross border basis, that Member States should not be able to require that a local paying agent be appointed. This would bring the UCITS Directive up-to-date in terms of recognizing that most business is now carried out using some form of technology and that it is no longer necessary to have a physical presence in the country where the investor is based. This would be of particular benefit to new market entrants, as the requirement to appoint a paying agent in various Member States can make marketing a UCITS in multiple Member States very costly and time consuming.

- 9) **Barriers to entry:** please document barriers to market entry arising from regulation that the EU should help address. Have the new rules given rise to any new barriers to entry for new market players to challenge incumbents or address hitherto unmet customer needs?

Failing to give adequate consideration to the effects of new legislation on new market entrants and/or small market players can severely impact competition and, in the financial services sector, can therefore be bad for investors. Many of the new rules and additional regulation imposed in response to the financial crisis have created or are creating higher barriers to entry and undermining the single market. This has led to fewer new market entrants and has also been driving smaller players out of business. For example, the costs and difficulties of complying with the AIFMD have decreased the amount of competition among AIFMs in the EU, as small players and AIFMs from third countries have been driven out. Although the AIFMD does contain an exemption for smaller AIFMs, the application of the exemption in various ways in each jurisdiction and the lack of certainty regarding their obligations have made the process exceedingly complicated for small AIFMs. The same can be said for AIFMs from third countries. Whilst we recognise that some regulation has been necessary, we consider that the impact of new regulation on small and/or new market players should be given greater consideration when legislation is developed. The impact of rules on cross-border business within the EU should also be taken into account.

Example 1: Marketing under AIFMD

To which Directive(s) and/or Regulation(s) do you refer in your example (if applicable, mention also the articles referred to in your example)?

AIFMD

Please provide us with an executive/succinct summary of your example

In order to lower barriers to entry for new market players, we would encourage the Commission to investigate the charging of passporting fees and imposition of additional requirements by Member States for the passporting of AIFs under the AIFMD. In relation to this we set out in annex 1 why AIMA considers that the national law provisions which seek to impose additional requirements on EU AIFs marketed solely to professional investors in accordance with Article 32 of the AIFMD are at odds with the harmonisation aim of the AIFMD.

We note that although these fees may not prevent AIFMs from using the passport provided by the AIFMD, they will act as a barrier for firms, in particular smaller firms, accessing capital markets. Furthermore, as discussed in annex 1, we consider that the imposition of fees and any other additional requirements on the operation of the AIFMD passport are contrary to the intention of the AIFMD, are likely to contribute to regulatory divergence and are likely to act as a disincentive to EU AIFMs looking to operate on a cross-border basis in the EU. We respectfully request that



the European Commission investigates the existence of such requirements across the EU and takes action to ensure that these requirements are removed.

We set out in Annex 2 a number of other issues that the AIFMD has introduced for AIFMs both within and outside the EU which we feel may either act as a barrier to entry for new market entrants and/or do not have any tangible benefits for investors.

An additional consideration in this context is whether stock exchanges could play a more prominent role in the recognition of funds for listing on multiple venues across the EU. For example, a fund listed on one stock exchange could automatically be recognised on other exchanges in the EU, subject to fulfilling certain criteria; this would obviate the need for additional re-recognition processes for each national listing, making it easier to distribute funds via multiple European jurisdictions.

Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data, etc.)

Please see attached documents (Annex 1 and Annex 2).

If you have suggestions to remedy the issue(s) raised in your example, please make them here

We consider that the imposition of fees and any other additional requirements on the operation of the AIFMD passport are contrary to the intention of the AIFMD, are likely to contribute to regulatory divergence and are likely to act as a disincentive to EU AIFMs looking to operate on a cross-border basis in the EU. We respectfully request that the European Commission investigates the existence of such requirements across the EU and takes action to ensure that these requirements are removed.

Example 2: Equivalence under EMIR

To which Directive(s) and/or Regulation(s) do you refer in your example (if applicable, mention also the articles referred to in your example)?

EMIR

Please provide us with an executive/succinct summary of your example

Article 13 of EMIR provides a valuable mechanism to avoid duplicative or conflicting rules for clearing, reporting and risk mitigation requirements under EMIR. Specifically, a transaction between one or more entities that is established in a third-country will be deemed to satisfy EMIR obligations where the third country benefits from a positive equivalence determination by the European Commission. However, determining 'equivalence' has proved challenging in practice - as evidenced by the protracted discussions between the European Commission and US authorities regarding the equivalence of the US framework for clearing, reporting and margin.

We therefore welcome the fact that an equivalence determination in respect of the US rules is imminent. We would also encourage the Commission to ensure that all future regulatory proposals include an appropriate range of mechanisms to deal with third-country entities. While equivalence is one possibility, there are others that can usefully be employed, including recognition and tailored registration requirements. We also believe there is scope for the Commission to continue to work with US counterparts and supranational bodies, including IOSCO, to promote a deeper understanding between individual authorities as to the appropriate ways of dealing with third-country entities.

Returning the equivalence framework under EMIR, we also hope that the Commission will be able to address the problem that arises for fund managers by virtue of the equivalence test being based solely on the physical place of 'establishment' of the counterparty(ies) and the possibility of regulated entities being unable to enjoy equivalence despite being caught within the scope of an equivalent jurisdiction's rule - for example, due to the profile of its investor base or its place of business.



Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data, etc.)

AIMA would recommend that the Commission consider amending of EMIR to take account of the issues identified with EMIR equivalence, as follows:

‘Establishment’ of a fund in a third-country jurisdiction: In the fund management context, a key question is whether an equivalence determination benefits an entity that is subject to the rules of a third country without legally being ‘established’, i.e. incorporated, there.

We use the common example of a Cayman Islands fund with a US investment manager. The investment fund will be subject to CFTC requirements as a ‘US person’ on account of the investment manager having its ‘principal place of business’ in the US. The fund might also meet the other limb of the CFTC US person test that is relevant for funds by being majority-owned by US person investors. In both cases, the Cayman fund would be subject to US rules despite the fund itself not being established in the US.¹⁷

Assuming that the European Commission ultimately adopts a positive equivalence determination in respect of the CFTC’s swaps regime, it is not clear that the Cayman fund managed by a US manager would be able to benefit from that equivalence determination when doing business with an EU counterparty subject to the clearing obligation.

EMIR’s definitions of financial and non-financial counterparty attach to the investment fund, rather than to the investment manager.¹⁸ Thus, when evaluating the possibility of benefitting from Article 13 equivalence when doing business with an EU counterparty subject to the clearing obligation, the relevant ‘counterparty’ would be the Cayman investment fund (the investment manager established in the US is not relevant). However, Article 13 of EMIR specifies that equivalence is available only where at least one of the counterparties is ‘established’ in an equivalent third-country jurisdiction. In our example, assuming that the European Commission has adopted a positive equivalence determination in respect of the US swaps regime, it is not clear that the Cayman fund would be able to benefit from Article 13 equivalence as the fund is not strictly ‘established’ in the US. This is despite the Cayman fund being subject to an equivalent enforceable OTC derivatives regime to that of EMIR.

Many investment funds are established in jurisdictions such as the Cayman Islands for structural and administrative reasons unrelated to their managers’ OTC derivatives trading, which will be covered by the regulatory regimes of the jurisdictions in which their managers trade. We are concerned, however, that the current wording of Article 13 would prevent non-EU investment funds that are not established in, but are subject to the rules of, an equivalent third-country jurisdiction from benefitting from equivalence. We note that this could subject such funds to duplicative rules that, in the case of mandatory clearing, would introduce irreconcilable conflicts in absence of equivalence - for example, it is not possible to clear in two separate jurisdictions under separate regimes at the same time.

If you have suggestions to remedy the issue(s) raised in your example, please make them here

We recommend that EMIR should be amended such that an equivalence determination can benefit entities that are either: (i) ‘established’ in; or (ii) ‘subject to the rules’ of an equivalent third country jurisdiction.

If a third-country entity is clearly ‘subject to the rules of’ an equivalent third-country jurisdiction, AIMA believes that it should be easy to prove that the entity is in compliance with those equivalent rules. Key information provided for the purposes of the equivalence determination - including that the regime is being ‘effectively applied and enforced’ - will

¹⁷ See <http://www.gpo.gov/fdsys/pkg/FR-2013-07-26/pdf/2013-17958.pdf>.

¹⁸ Although the status of the investment manager is relevant, for example for categorisation as a Financial Counterparty under Article 2(8) of EMIR.



demonstrate whether the relevant entity is covered by the equivalent jurisdiction's rules and that these rules are enforceable against it in the same way as if it were physically 'established' in that jurisdiction.

We propose the following drafting amendment to Article 13 of EMIR Level 1 text:

Article 13(3)

An implementing act on equivalence as referred to in paragraph 2 shall imply that counterparties entering into a transaction subject to this regulation shall be deemed to have fulfilled the obligations contained in Articles 4, 9, 10 and 11 where at least one of the counterparties is established in, or subject to the rules of, that third country.

'At least one counterparty' established in that third country: AIMA would recommend and see great benefit in extending the availability of equivalence under Article 13 to all entities subject 'to the rules of' an equivalent third-country - including entities that are established in the EU. Thus, if at least one counterparty to a transaction is 'subject to the rules' of an equivalent jurisdiction, AIMA would strongly recommend that both counterparties be deemed to meet the requirements of EMIR by complying with the rules of the equivalent third-country jurisdiction.

We believe that this would provide the greatest flexibility to account for the interaction between different regulatory regimes, enabling the appropriate regulatory regime to be applied according to the true jurisdictional nexus of the particular transaction. We note that the scope of different jurisdictions' rules implementing the G20 commitments on OTC derivatives markets can vary, leading to potential conflicts should a particular transaction fall within multiple regimes and mutual recognition be unavailable. We have stressed this point to the CFTC in relation to its substituted compliance framework - in particular the need to extend the availability of substituted compliance to transactions which involve US persons when the true nexus of the transaction falls in an equivalent jurisdiction.

Overall, AIMA would highlight the global nature of the derivatives markets and their participants, and recommend that the flexibility offered by an equivalence determination and mutual recognition under Article 13 be available for all derivative transactions between all counterparties which are subject to the rules of that equivalent jurisdiction, regardless of where they are established.

Example 3: Depository passport

To which Directive(s) and/or Regulation(s) do you refer in your example (if applicable, mention also the articles referred to in your example)?

AIFMD

Please provide us with an executive/succinct summary of your example

AIMA considers that another area where barriers to market entry arise from regulation that the EU should help address is in relation to the provision of depository services on a cross border basis. AIMA considers that introducing a depository passport under both the AIFMD and UCITS Directive would reduce barriers to entry for depositaries and increase competition in the market.

Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data, etc.)

At present, Article 23(5) of the AIFMD and Article 23(1) of the UCITS Directive require a depository to be established in the home Member State of the AIF/UCITS.¹⁹ These requirements prevent depositaries from both establishing themselves in various Member States and also from

¹⁹ For non-EU AIFs, in the third country where the AIF is established or in the home Member State of the AIFM managing the AIF or in the Member State of reference of the AIFM managing the AIF.



establishing themselves in one Member State and providing their services in a different Member States.

Article 49 of the Treaty on the Functioning of the European Union (the 'TFEU') requires that "restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited." Article 56 of the TFEU requires that "restrictions on freedom to provide services within the Union shall be prohibited in respect of nationals of Member States who are established in a Member State other than that of the person for whom the services are intended." Prior to the implementation of the AIFMD and the UCITS V Directive (Directive 2014/91/EU), there were national divergences in the application of depositaries' duties and liabilities. At this time the restriction on the freedom to provide depositary services on a cross border basis could have been justified. However, following the implementation of the UCITS V Directive and the AIFMD, national laws relating to who can act as a depositary, depositaries duties, delegation of depositary functions and depositary liability are harmonised. This leaves no scope for different national laws across the Member States as regards the depositary requirements. It therefore seems Article 23(1) of the UCITS Directive and Article 23(5) of the AIFMD should be removed and a depositary passport should be adopted.

Furthermore, the creation of ESMA has strengthened the EU regulatory framework. ESMA has the powers under the regulation which establishes it (Regulation No (EU) 1095/2010, the 'ESMA Regulation') to ensure greater harmonisation in regulatory practices and supervision at the EU level. For example, the ESMA Regulation permits ESMA to adopt guidelines and recommendations with a view to promoting the safety and soundness of markets and convergence of regulatory practice²⁰. ESMA also plays a role in ensuring convergence in supervisory practice²¹. For example, ESMA is required to organise and conduct peer review analyses of competent authorities, including issuing guidelines and recommendations and identifying best practices, in order to strengthen consistency in supervisory outcomes²². ESMA can also intervene where there has been a breach of EU law in relation to the UCITS directive or the AIFMD²³. The role of ESMA within the EU supervisory framework therefore adds further weight to the argument that there is no longer a justifiable reason for not permitting a depositary passport.

If you have suggestions to remedy the issue(s) raised in your example, please make them here

Article 23(1) of the UCITS Directive and Article 23(5) of the AIFMD should be removed and a depositary passport should be adopted.

Example 4: Withholding taxes

To which Directive(s) and/or Regulation(s) do you refer in your example (if applicable, mention also the articles referred to in your example)?

Please provide us with an executive/succinct summary of your example

Capital and income flows should be free of withholding taxes, as in the Eurobond market, since the imposition of withholding taxes may eliminate the margin on the transaction for the capital provider. Where a Member State would impose withholding taxes in the absence of a holder of the financial instrument meeting threshold requirements, there should be a minimum of compliance in order to establish entitlement to this. Again, we note the work being undertaken by the OECD and the EU on initiatives in this area (e.g. the Tax Barriers and Business Advisory Group (T-BAG) report and Commission Recommendations, the Tax Relief and Compliance

²⁰ See Article 9(2) of the ESMA Regulation and see also Article 16(1), which permits ESMA to issue guidelines and recommendations addressed to competent authorities or financial market participants in order to establish "consistent, efficient and effective supervisory practices within the ESFS, and to ensur[e] the common, uniform and consistent application of Union law."

²¹ Other powers which may be of relevance are those such as Article 19, which gives ESMA the power to settle disagreements between competent authorities in cross-border situations and Article 29, which requires ESMA to "play an active role in building a common Union supervisory culture and consistent supervisory practices."

²² See Article 8(1)(e) of the ESMA Regulation.

²³ See Article 17 of the ESMA Regulation.



Enhancement (TRACE) project) and there exist similar mechanisms in Member States (e.g. the UK's "passport scheme" and proposed private placement exemption) which streamline availability of withholding tax relief. Delays in establishing entitlement to withholding tax exemptions create uncertainties and affect the cash flow of the parties.

Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data, etc.)

Withholding taxes on interests and dividends paid to residents of other member states of EU create barriers to cross-border flows between Member States and a segmentation of Europe's Internal Market. The ability of a lender to receive dividends without deduction of withholding tax would be crucial, facilitating intra-EU trade and the creation of an efficient CMU²⁴. To pursue that objective, we encourage the EU Commission to take the lead on the work undertaken through the TRACE project. The benefits that TRACE is designed to provide are: i) more reliable treaty access for funds ii) increased comfort for tax authorities that treaty benefits are being given only to qualified end recipients and iii) reduced administrative burden for both tax authorities and private sector through avoiding the requirement of certificates of Tax Residence.²⁵ The implementation of the EU Revised Directive on Administrative Cooperation in the area of automatic exchange of information could significantly reduce, and in some instances eliminate, many of the costs associated with implementing a pan-EU harmonised tax relief system

Moreover, the processes put forward in order to obtain the reimbursement of withholding taxes can be lengthy, costly and with administrative and practical impediments. To improve the access to tax treaty benefits, eliminate double taxation, and thus to facilitate investment by non-residents, some measures can be taken:²⁶ (i) the tax authorities should provide adequate guidance to simplify treaty access to foreign investors, with appropriate rules, (ii) it should be adopted within the EU simplified relief at source procedures, (iii) the EU Member States should put in place efficient, and streamlined procedures to reclaim excessive withholding taxes in accordance to tax treaties.²⁷

²⁴ Bank of England – response to CMU action plan, May 2015: “Consideration needs to be taken with respect to the withholding tax differential between listed and non-listed securities. For example, in the United Kingdom, in contrast to interest on bank loans, debt listed on a stock exchange and quoted Eurobonds, non-listed securities generally attract a withholding tax. As a result, overseas lenders receive post-tax interest (withholding tax is collected at source from the interest payer), significantly reducing the return on their non-listed transactions and thus disincentivising cross-border investment into the United Kingdom. More generally, when there is a suitable tax treaty between the country of the borrower and the foreign lender’s jurisdiction there may be a withholding tax exemption. Still, the claims process can be complicated and time-consuming”.

²⁵ EFAMA response – EU Commission consultation on building a Capital Markets Union (May 2015).

²⁶ The OECD Action Plan on Base Erosion and Profit Shifting (BEPS) identified 15 actions to address BEPS in a holistic manner. One of these areas for reform was to “prevent the granting of treaty benefits in inappropriate circumstances” (Action 6). Action 6 proposed the inclusion of two complementary/alternative tests which would need to be met in order to access treaty entitlement – a Principal Purpose Test (PPT) and the Limitation on Benefits rule (LOB).

In this context, AIMA would like to raise the issues arising with respect to treaty entitlement of collective investment vehicles (CIVs) and non-CIV funds. We support the assumptions of the OECD’s 2010 CIV Report, which recognises the importance of widely held funds being able to access treaty benefits. This report should continue to be the basis for determining treaty access for CIVs, particularly with regard to CMU’s objective of promoting cross-border funds. As a result, we would strongly recommend that CIVs should be expressly exempted from any possible application of both the LOB and PPT rules as a result of BEPS Action 6.

We note that neither the 2010 CIV Report nor the OECD’s 2015 Report on Treaty abuse dealt with treaty entitlement issues relating to collective investment funds which are not widely held, regulated and diversified. This may include some classes of private equity funds and alternative funds which share some of the characteristics of CIVs. In particular, (like CIVs) non-CIV funds are established for bona fide commercial purposes. As such, it is equally important that the output from Action 6 imposes no additional impediments on bona fide commercial non-CIV funds ability to obtain treaty benefits. We would recommend that work similar to the 2010 CIV Report needs to be undertaken through the OECD Informal Consultative Group to identify issues across the various types of non-CIV funds and develop practical solutions for treaty entitlement.

European Property Federation – response to the EU Commission on Capital Markets Union: *The aim of collective investment undertakings should be for ultimate investors to suffer no more tax than if they had invested in the underlying assets directly while at the same time benefitting from the economies of scale and professional management provided by collective investment. In this context, the ability to access double tax treaties (DTTs) is crucial as otherwise an investment may suffer multiple layers of taxation, rendering it economically unviable.*

²⁷ BNP Paribas response to Green paper on Building a Capital Markets Union



If you have suggestions to remedy the issue(s) raised in your example, please make them here

The EU should progress on a doctrine with common agreed definitions. It is essential to create a tax-attractive environment in the EU, which means stable, certain and non-burdensome tax rules. Generally speaking, consistent and predictable tax rules are important so that the economic actors can invest in an environment with legal security.

Examples where withholding tax exemptions have already been implemented include Italian mini-bonds and UK private placements. This should enhance cross-border investment and help develop deeper and more liquid markets in these products. Ideally, any withholding tax relief should be applied at source - at the time of payment of the securities income, rather than by refund. Alternatively, and in cases where exemptions already apply - such as in the case of double-tax treaties - EU Member States should ensure that the refund process is fast and simple.

We note the following as other issues to consider:

- **Structural differences between tax regimes in the treatment of equity, debt and hybrid capital instruments.** While there is scope for EU measures to address particular differences where either tax avoidance or an unfair tax advantage for a Member State is seen to arise (and we note in this connection the work currently being undertaken by the OECD and the EU), this issue as a general principle should be a matter for each Member State to consider in the context of the integrity of its tax system. The tax treatment of an instrument for the issuer and holder is a relevant consideration in a capital markets transaction but it may affect the relative attraction of the instrument rather than the functioning of the CMU²⁸.
- **Restrictions or incentives that may have a discriminatory effect.**²⁹ Again, there is a balance to be found between measures that may be justified (such as tax incentives for R&D expenditure or tax avoidance rules) which should be left to each Member State to provide and administer as it sees fit and those which may be abusive or detrimental to the CMU (e.g. where the benefit of an incentive is not effectively available where a holder of the instrument is not resident or established in the applicable Member State). Such restrictions may operate at a remove from the affected person's underlying capital markets activity, e.g. measures which impede the raising of capital by a collective investment scheme (as the German fund taxation rules considered in the *van Caster* case) or they may, by deeming a connection between the issuer and the holder of the financial instrument, recharacterise the nature of the financial instrument for tax purposes (e.g. from debt to equity).
- **Liability to tax in the issuer's jurisdiction for holders of the financial instrument who are resident outside that jurisdiction in respect of income and capital gains on the financial instrument.** While the extent of liability is in principle a matter for each Member State to determine in its tax laws, a CMU might benefit from greater uniformity in the minimum circumstances in which such liability would (if at all in a particular Member State) arise.
- It will be important that any steps implemented in EU jurisdictions resulting from the OECD's **Base Erosion and Profit Shifting initiative** are done with the European Commission's objective of moving towards a more integrated capital markets union

²⁸ London Stock Exchange group - Response to the EU Commission green paper on CMU *"Recent evidence from the UK provides strong evidence in favour of reducing the taxation of equity. Since the abolition of the UK's own FTT, Stamp Duty, for companies quoted on the UK's leading market for SMEs, AIM, there has been the largest issuance since the financial crisis (£8 bn in new and further issuance in 2014 alone). Taken together with the inclusion of AIM companies in tax-advantaged 'ISA' accounts, there has been a significant inflow of retail investment into SMEs (£6 bn in one year), providing valuable liquidity and helping to give individual citizens a stake in the future growth of some of Europe's promising and growing companies"*.

²⁹ European investment funds have, for many years and with slow success, challenged, primarily through the European Court of Justice, the differential withholding treatment between cross border and domestic investors. Progress in this direction continues, but not all discriminatory treatment is yet eliminated.



(CMU) in mind (i.e. an agreement in the OECD's multilateral instrument of a dispute resolution mechanism should be able to facilitate cross-border transactions).

Interactions of individual rules, inconsistencies and gaps

- 10) **Links between individual rules and overall cumulative impact:** given the interconnections within the financial sector, it is important to understand whether the rules on banking, insurance, asset management and other areas are interacting as intended. Please identify and explain why interactions may give rise to unintended consequences that should be taken into account in the review process. Please provide an assessment of their cumulative impact. Please consider whether changes in the sectoral rules have affected the relevancy or effectiveness of the cross-sectoral rules (for example with regard to financial conglomerates). Please explain in what way and provide concrete examples.
- 11) **Definitions:** different pieces of financial services legislation contain similar definitions, but the definitions sometimes vary (for example, the definition of SMEs). Please indicate specific areas of financial services legislation where further clarification and/or consistency of definitions would be beneficial.
- 12) **Overlaps, duplications and inconsistencies:** Please indicate specific areas of financial services legislation where there are overlapping, duplicative or inconsistent requirements.

As noted in our response to question 6, reporting requirements are a significant source of regulatory burden our members. Some of this burden stems from the interaction between different legislative texts, and the reality that rules that are written on a sectoral basis are not necessarily coherent when viewed together. For example, both EMIR and MiFID2 require reports to be made to regulators or trade repositories on certain derivatives transactions. While MiFID2 envisages the possibility of reliance on EMIR reports, it is not clear that this is a workable solution, given that EMIR and MiFID2 reporting fields and timelines were not written in a way that provides consistency at the level of the detailed requirements. We believe that there is a strong case to revisit reporting obligations across existing financial services legislation with a view to achieving greater coherence and in order to limit the number of reports that ultimately need to be submitted by market participants.

- 13) **Gaps:** while the recently adopted financial legislation has addressed the most pressing issues identified following the financial crisis, it is also important to consider whether they are any significant regulatory gaps. Please indicate to what extent the existing rules have met their objectives and identify any remaining gaps that should be addressed. Rules giving rise to possible other unintended consequences

To which Directive(s) and/or Regulation(s) do you refer in your example (if applicable, mention also the articles referred to in your example)?

MIFID2/MiFIR

Please provide us with an executive/succinct summary of your example

AIMA believes that electronic trading can play an important role in fostering competition in fixed income markets, improving pricing and liquidity, and facilitating direct interaction between end users in secondary markets. Accordingly, we welcome measures in MiFID2 that will foster the migration of OTC derivatives trading to regulated venues. We are concerned, however, that the potential benefits of this move will not be realized unless they are applied in a way that opens up the current two-tier market.

Please provide us with supporting relevant and verifiable empirical evidence for your example (please give references to concrete examples, reports, literature references, data, etc.)

Currently, a small group of dealers are able to transact with each other on exclusive "dealer-only" trading platforms, commonly referred to as the "inter-dealer" or "D2D" market. These platforms



deny access to all other types of market participants, including investors (e.g., investment funds, insurance companies, corporations, etc.). For investors, the only way to transact with that group of dealers is either bilaterally or on a limited number of “dealer-to-customer” or “D2C” trading platforms. This market structure is suboptimal in a number of respects, as it restricts the ability of investors to execute freely with any other counterparty, limits investors’ choice of trading protocols, compromises investors’ ability to execute the most favourable prices, inhibits new liquidity providers from entering the market, and engenders concentration of risk in the dealer community.

If you have suggestions to remedy the issue(s) raised in your example, please make them here

We believe that the Commission should use the implementation of MiFID2 as an opportunity to address this situation. Specifically, it is important that non-discriminatory access requirements are applied across all trading venues to ensure that the largest incumbent dealers are not in a position to push venues to maintain historical market structures that advantage the dealer community at the expense of investors.

- 14) **Risk:** EU rules have been put in place to reduce risk in the financial system and to discourage excessive risk-taking, without unduly dampening sustainable growth. However, this may have led to risk being shifted elsewhere within the financial system to avoid regulation or indeed the rules unintentionally may have led to less resilient financial institutions. Please indicate whether, how and why in your view such unintended consequences have emerged.

Whilst we understand the Commission’s concern that recent EU legislation may have led to risk being shifted elsewhere in the financial system to avoid regulation, we strongly disagree that this has in fact happened. In particular, we would highlight that the transition to non-bank finance does not automatically indicate that risk has moved from the highly-regulated banking sector to the supposedly unregulated ‘shadow banking’ sector, but that certain risks may have shifted from the highly concentrated banking industry to the far more diverse alternative finance markets, many of which, for example, asset managers, are already subject to a comprehensive regulatory framework of their own.

- 15) **Procyclicality:** EU rules have been put in place to make the financial system less procyclical and more stable through the business and credit cycle. Please indicate whether some rules have unintentionally increased the procyclicality of the financial system and how.

One of the key post-crisis reform measures has been the development of the EMIR clearing obligation in respect of liquid OTC derivatives contracts; this will come into effect from 21 February 2016. While we have consistently expressed our support for the move to central clearing, it is vital to keep under review whether clearing rules as they are being implemented are proving effective in reducing systemic risk, particularly when viewed in light of other measures that are changing capacity in the financial system, most notably Basel III.

In this regard, we remain concerned that the risk-reducing goals of central clearing could be greatly undermined if there is no comprehensive agreement between EU and US authorities on how to deal with the interaction of EU and US rules, for example through joint approaches on equivalence and substituted compliance. As the clearing start date draws clearer, the need for such an agreement is becoming ever clearer.

At the same time, we welcome efforts to formulate policy measures to deal with the recovery and resolution of CCPs, given that central clearing involves the transfer of bilateral credit risk to CCPs in a manner which greatly increases their systemic importance. We have also raised the point in the context of the EMIR review that policymakers should have at their disposal the power to be able to suspend the EMIR clearing obligation if it becomes necessary to do so (for example, if the liquidity of a cleared contract undergoes a significant reduction).



Annex I

Why AIMA considers that the imposition of fees and any other additional requirements on the operation of the AIFMD passport are contrary to the intention of the AIFMD

Background

The Alternative Investment Fund Managers Directive (AIFMD) deadline for transposition Member States was 22 July 2013. From 22 July 2013 onwards, authorised EU alternative investment fund managers (AIFMs) of EU alternative investment funds (AIFs) have been able to market their EU AIFs throughout the EU using the AIFMD marketing passport.

It has been brought to our attention that several Member States are imposing additional fees or requirements on the use of the passport. In this annex we explain why the Commission should prevent the imposition of these additional fees and requirements as they are not in line with the intention of the AIFMD to create a harmonised single market for EU AIFMs marketing EU AIFs to professional investors in the EU.

The AIFMD passporting process

The AIFMD provides that the passport should operate in the following way:

- The EU AIFM obtains an authorisation in the EU AIFM's home Member State and that authorisation is then valid for all Member States;³⁰
- The EU AIFM then notifies its home Member State that it intends to market in another Member State using the prescribed documentation in Annex IV of the AIFMD in respect of each EU AIF that it intends to market;
- The EU AIFM's home Member State checks that the notification is complete;
- Provided that the EU AIFM complies with and will continue to comply with the AIFMD, the home Member State submits the notification to the host Member State;
- The EU AIFM's home Member State notifies the EU AIFM that the notification has been made; and
- The EU AIFM may start marketing the EU AIF in the host Member State of the EU AIFM as of the date of that notification from its home Member State.³¹

Article 32 of the AIFMD, which sets out this process, does not allow Member States any discretion to any levy any fees or impose additional requirements on an EU AIFM which is authorised in another Member State and wishes to market under the passport in a host Member State.

The intention of the AIFMD

In order to find what the intention of the AIFMD is, it is worth considering the Directive's recitals. Recital 2 of the AIFMD provides that:

"The impact of AIFMs on the markets in which they operate is largely beneficial, but recent financial difficulties have underlined how the activities of AIFMs may also serve to spread or amplify risks through the financial system. Uncoordinated national responses make the efficient management of those risks difficult. This Directive therefore aims at establishing common requirements governing the authorisation and supervision of AIFMs in order to provide a coherent approach to the related risks and their impact on investors and markets in the Union."

³⁰ In order to obtain a marketing passport under the AIFMD, an AIFM must first become authorised in accordance with the AIFMD in its home Member State. The AIFMD sets out the process for obtaining authorisation as an AIFM in Chapter II. (Article 7(1) of the AIFMD) This authorisation is valid for all Member States. (See Article 8(1) of the AIFMD.)

³¹ See Article 32 of the AIFMD.



Recital 4 of the AIFMD sets out that the aim of the AIFMD is:

“to provide for an internal market for AIFMs and a harmonised and stringent regulatory and supervisory framework for the activities within the Union of all AIFMs, including those which have their registered office in a Member State (EU AIFMs) and those which have their registered office in a third country (non-EU AIFMs).” (Emphasis added)

Recital 15 then states that:

“the authorisation of EU AIFMs in accordance with this Directive covers the management of EU AIFs established in the home Member State of the AIFM. Subject to further notification requirements, this also includes the marketing to professional investors within the Union of EU AIFs managed by the EU AIFM and the management of EU AIFs established in Member States other than the home Member State of the AIFM.” (Emphasis added)

Recital 59 provides that the AIFMD:

“also lays down the conditions subject to which EU AIFMs may market the units or shares of EU AIFs to professional investors in the Union. Such marketing by EU AIFMs should be allowed only in so far as the AIFM complies with this Directive and the marketing occurs with a passport....” (Emphasis added)

Taking these recitals together it can be concluded that the AIFMD seeks to establish a harmonised regulatory framework for EU AIFMs of EU AIFs marketing to professional investors in the EU under which marketing throughout the EU to professional investors shall be permitted so long as the EU AIFM complies with the AIFMD and the marketing occurs with a passport (i.e. notification requirements are fulfilled).

Are there any justifications for the charging of fees?

Member States which are imposing additional fees or requirements on EU AIFMs which are marketing in their jurisdiction under the AIFMD passport may seek to use Article 32(5) of the AIFMD to justify their actions. Article 32(5) of the AIFMD provides that arrangements made for the marketing of AIFs and, where relevant, information on the arrangements established to prevent units or shares of the AIF from being marketed to retail investors, shall be subject to the laws and supervision of the host Member State of the EU AIFM. This does not, however, provide a legitimate basis for a host Member State to charge fees or impose additional requirements for the use of the passport. In particular, we would highlight the fact that applicability of national laws under this provision relates to the “arrangements made for the marketing”, not to the use of the passport itself. If such arrangements are indeed implemented, Article 32(5) of the AIFMD merely states which national law is applicable to these arrangements. It does not mean that Member States may start adding requirements or conditions for the passport to be granted.

Article 32(1) of the AIFMD provides that as soon as the conditions laid down in the Article are met, an EU AIFM may begin marketing. The conditions laid down are those referred to in the discussion above, which contain no reference to the imposition of additional fees or requirements. We therefore consider that the Commission should not allow Member States to impose additional fees or requirements on AIFMs which are seeking to market in host Member States using the AIFMD passport.

If, however, a different interpretation of Article 32(5) is taken and it is concluded that this provision does permit Member States to impose fees or additional requirements on EU AIFMs operating under that marketing passport, those fees or requirements should be:

- i. proportionate and strictly limited in scope to those matters referred to in Article 32(5) of the AIFMD, i.e. to information about arrangements made for the marketing of AIFs and, where relevant, information on the arrangements established to prevent units or shares of the AIF from being marketed to retail investors, including in the case where the AIFM relies on activities of independent entities to provide investment services in respect of the AIF;



- ii. applicable to the AIFM and based on the authorisation of that AIFM to market in the host Member State and not based on each AIF which is marketed in the host Member State; and
- iii. applied on a non-discriminatory basis to AIFMs which are authorised in that host Member State and AIFMs authorised in another Member State.

In relation to the first of these points, any additional requirements should be limited in this way as Article 32 explicitly states that:

“an authorised EU AIFM may market units or shares of an EU AIF that it manages to professional investors in another Member State than the home Member State of the AIFM as soon as the conditions laid down in this Article are met.”

There are no other provisions under Article 32 which could be used to argue that the host Member State may impose additional requirements on the AIFM. Any additional requirements should therefore be limited to those matters covered by Article 32(5) of the AIFMD or Member States will be breaching the requirements of the Directive.

In relation to the second of the points mentioned above, the AIFMD seeks to establish a passport for the manager and not for each individual AIF. Recital 10 of the AIFMD states that:

*“This Directive does not regulate AIFs. AIFs should therefore be able to continue to be regulated and supervised at national level. It would be disproportionate to regulate the structure or composition of the portfolios of AIFs managed by AIFMs at Union level and it would be difficult to provide for such extensive harmonisation due to the very diverse types of AIFs managed by AIFMs. This Directive therefore does not prevent Member States from adopting or from continuing to apply national requirements in respect of AIFs established in their territory. **The fact that a Member State may impose requirements additional to those applicable in other Member States on AIFs established in its territory should not prevent the exercise of rights of AIFMs authorised in accordance with this Directive in other Member States to market to professional investors in the Union certain AIFs established outside the Member State imposing additional requirements and which are therefore not subject to and do not need to comply with those additional requirements.**”*(Emphasis added)

Any requirements which are placed on an EU AIFM which is seeking to market its EU AIFs under the marketing passport should therefore be limited to requirements which relate to the AIFM and not to each individual AIF which the EU AIFM is seeking to market.

In relation to the third of the points mentioned above, Article 49 of the Treaty for the Functioning of the European Union (TFEU) prohibits restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State, including the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, subject to certain exceptions. There appears to be no legitimate reason for Member State to argue that certain measures should be imposed on foreign AIFMs which are not applied to their own domestic AIFMs. Any restrictions placed on AIFMs must therefore be applied on a non-discriminatory basis to AIFMs established in that Member State and those which access their market using the AIFMD marketing passport.

The operation of the Directive of Undertakings for Collective Investments in Transferable Securities (UCITS) as compared to the AIFMD

As explained above, the AIFMD seeks to establish a harmonised regulatory framework for EU AIFMs of EU AIFs marketing to professional investors in the EU under which marketing throughout the EU to professional investors shall be permitted so long as the EU AIFM complies with the AIFMD and the marketing occurs with a passport. The UCITS Directive was the first to introduce a passport in the area of financial services. Like the AIFMD, the UCITS Directive provides that a notification procedure shall be used by Member States to allow a UCITS to market its units in a Member State other than its home Member State. In considering how the AIFMD passport is intended to operate, one might, therefore, look to the UCITS Directive to consider whether additional fees or requirements are justified. There are, however, several reasons why it should be concluded that the passport under



the UCITS Directive is intended to operate in a different way to the AIFMD passport. These are as follows:

- the UCITS Directive foresees the payment of notification fees: the AIFMD does not;
- the UCITS Directive also foresees that a UCITS may need to appoint a paying agent in the host Member State: the AIFMD does not; and
- the UCITS Directive passport permits marketing to retail investors: the AIFMD passport does not.

1. Recognition of the payment of notification fees

The AIFMD does not refer to the payment of notification fees in any part of the legislation. By way of contrast, recital 67 of the UCITS Directive explicitly states that “to facilitate the access to the markets of other Member States, *it is important that notification fees are disclosed.*” (Emphasis added). The UCITS Directive therefore explicitly foresees that Member States may impose notification fees when a UCITS operates under the passport, whereas the AIFMD does not. This is also reinforced by the fact that the UCITS Level 2 measures include a notification letter which allows host Member States to charge fees.³² The AIFMD simply states that the AIFMD notification shall comprise the documentation and information set out in Annex IV to the AIFMD. This does not allow for the imposition of additional fees or requirements.

2. The appointment of a paying agent

Unlike the AIFMD, the UCITS Directive also contemplates that a UCITS may need to appoint a paying agent in the host Member State. Article 92 of the UCITS Directive provides that:

“UCITS shall, in accordance with the laws, regulations and administrative provisions in force in the Member State where their units are marketed, take the measures necessary to ensure that facilities are available in that Member State for making payments to unit-holders, repurchasing or redeeming units and making available the information which UCITS are required to provide.”

No similar provision exists in the AIFMD. Member States should therefore not be requiring EU AIFMs which are operating under the AIFMD passport to appoint a paying agent in order to market in their jurisdiction.

3. Retail vs professional investors

The AIFMD EU marketing passport is for professional investors only. We consider that retail investor protection considerations (such as paying agency requirements for UCITS via Article 92 of the UCITS Directive), which are not set out in the AIFMD, should not de facto apply to AIFMD where only professional investors are being marketed to.

Legislators at AIFMD Level 1 were cognisant of the intentional difference between a passport available only for products to be marketed to professional investors and products which could be marketed to retail investors. In this regard, the AIFMD purposefully makes no reference to any further requirements for the professional investor passport. Consequently national member states should not have an ability to gold-plate what is a harmonised professional investor passporting regime.

Application of higher standards by national member states to the EU marketing passport is permissible under the terms of AIFMD, but only where there is an intention to extend the marketing of the passported AIF to retail investors via Article 43. Article 43 sets out the framework (and the constraints) within which the member state can apply these additional retail investor conditions. We therefore consider that applying measures such as those set out in Article 92 of the UCITS Directive are inappropriate or disproportionate when applied to the marketing of an AIF to professional investors.

³² See Commission Regulation 584/2010, Annex I, Part B.



It can be seen from the analysis above that the UCITS framework is not comparable to the AIFMD framework in these important respects and does not constitute a precedent which should not be used to justify the application of fees or additional requirements on the application of the AIFMD passport.

Conclusion

The margin of discretion available to the Member States is entirely determined by the AIFMD itself and must be inferred from its wording, purpose and structure. In that connection it should be pointed out that, as is clear from the second and the fourth recital of the AIFMD, the purpose of the AIFMD is to establish a harmonised regulatory and supervisory framework for the activities within the Union of all AIFMs, to facilitate the free movement of the provision of these services and to provide a coherent approach to the related risks and their impact on investors and markets in the Union. Unlike the UCITS Directive, the AIFMD contains no provision expressly permitting Member States to charge fees or add additional requirements to the use of the passport.

Although Article 32(5) could be read as providing derogation by referring to certain matters to national law does not mean that in regard to the matters which it regulates Member States can maintain rules which defeat the aim of harmonisation.³³ In those circumstances Article 32 of the AIFMD cannot be interpreted as giving the Member States the possibility of charging fees or adding additional regulatory requirements. If additional fees or requirements are placed on AIFMs marketing under the AIFMD passport, they should therefore be limited to the matters covered by Article 32(5) of the AIFMD and applied in a non-discriminatory way to domestic and foreign AIFMs. We therefore request that the Commission investigates the existence of such requirements across the EU and takes action to ensure that the purpose of harmonisation envisaged by the AIFMD is not defeated.

³³ See paragraphs 16-21 of Case C-52/00.



Annex II

Issues facing the hedge fund industry and its investors caused by the AIFMD

AIMA has been corresponding with the European institutions since the early stages of the development of the AIFMD and since the inception of the Directive, we have been supportive of appropriate and proportionate regulation of AIFMs which would provide national regulators with the information they need to monitor financial stability effectively within their markets. However, we have had and remain to have concerns that in certain areas the AIFMD is overly restrictive, resulting in higher barriers to entry, less competition and decreasing investor choice within Europe. AIMA's concerns in relation to the AIFMD include the following:

- **Passporting fees:** As set out in annex I above, we consider that the passporting fees being charged by certain Member States conflicts with the objective of the AIFMD to create a harmonised market for the marketing of AIFs across the EU. We therefore request that the Commission investigates the existence of such requirements across the EU and takes action to ensure that the purpose of harmonisation envisaged by the AIFMD is not defeated;
- **Annex IV reporting:** As mentioned above in our response to question 6, Annex IV reporting has proved extremely challenging for AIFMs. Annex IV reporting requires managers to compile large quantities of data from a number of sources and to perform complex calculations. This has cost all AIFMs who manage an EU AIF or market an AIF in the EU a great amount of time and money with no visible benefits for investors, regulators or the industry. We would welcome greater transparency being given to AIFMs as to what is being done with the data in the reports that they are taking considerable time and effort to complete. We also consider that in order for data compiled as a result of the AIFMD to be able to give competent authorities an indication of the systemic importance of an AIFM/AIF, that there needs to be consistent interpretations of data required and received, as well as supervisory cooperation and coordination. We welcome ESMA's efforts to give guidance on the Annex IV reporting requirements, but consider that in order to improve Annex IV reporting, ESMA should produce a more comprehensive common reporting methodology, instructions and interpretations. We would also welcome ESMA (or another designated body) acting as the single portal for receipt of Annex IV reports;
- **Leverage:** The gross and commitment methods currently used under the AIFMD are not sufficient or appropriate for all types of AIFs and are misleading to managers, investors as well as competent authorities. We set out further details on the AIFMD's leverage calculation methodologies and AIMA's suggestions for improvement in annex III;
- **Depository:** The depository requirements of the AIFMD have both increased operational costs for AIFMs and decreased competition. As only a limited number of institutions have become authorised as depositaries given, amongst other things, the quasi-strict liability in respect of the loss of a financial instrument that can be held in custody, AIFMs have had limited bargaining power in the negotiation of the depository agreements. Furthermore, concentrating risk in the small number of entities that are authorised as depositaries has potential to create systemic risk concerns. The depository functions were previously carried out mainly by an AIF's prime broker. We consider that there should not be a requirement for an AIF to have a single depository so long as the functions are carried out by entities that are subject to adequate regulation of custody services. We also consider that the rules regarding the location of depositaries should be made less restrictive. In particular, if the passport is extended for EU AIFMs to their non-EU AIFs, it would cause less market disruption if they were able to retain their depository-lite provider and expand their activities so as to comply with the whole of Article 21 of the AIFMD (with the exception of Article 21(5)(b)) rather than needing to appoint an entirely new entity which is located in either their home Member State or the country where the AIF is domiciled, where depositaries may be limited in numbers; and
- **Functional and hierarchical separation of risk management and portfolio management:** The Level 2 Regulation requires an AIFM's risk management function to be functionally and hierarchically separate from the portfolio and risk management functions. We consider that the Level 2 requirements currently lack important flexibility and that requiring separate personnel to carry out the risk management function in smaller firms may be disproportionate. There may



therefore be instances where a full separation of the risk management function may not be advisable. Where such a separation is not possible, it should be possible for firms to meet a list of safeguards, as was suggested by ESMA in their Final Advice on the Level 2 measures, which would need to be met in order to maintain the independence of the risk management function.³⁴

³⁴ See Box 30 of ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive at: http://www.esma.europa.eu/system/files/2011_379.pdf



Annex III

Leverage under the AIFMD

The AIFMD leverage calculation methods

The Level 2 Regulation adopted two measures of leverage which had not previously been standard measures of leverage used by the industry: the gross method and the commitment method. In recognition of this and given that these two new measures of leverage might not be suitable in all situations, Article 6(2) of the Level 2 Regulation requires the Commission to carry out a review of these calculation methods in order to decide whether these methods are “sufficient and appropriate for all types of AIFs”, or if an additional and optional method for calculating leverage should be developed.

Concerns with the gross method

The gross method suffers from all of the deficiencies noted in the section above. The method specifies that the “exposure” of an option is the delta-equivalent amount; this is a slight improvement to using the notional amount, but is still an inadequate measure of option risk. For example, as stated above, a one-month at-the-money call option on the S&P 500 index generally will have a value of approximately 1% of its notional amount compared to its delta of 50%; the Gross Method would therefore indicate an exposure for such an option position which is 50 times greater than its maximum possible loss.

Under the gross method, the exposure of an AIF is the sum of the absolute values of all positions valued in accordance with the AIFMD. Where an AIF invests in derivative instruments, the absolute positions of each derivative instrument will be added to each other, which can lead to some odd results, as shown by the following example involving call options:

Trade with two option legs on S&P 500 (SPX)

SPX Spot: 1994

Both options are expiring on October 18, 2014 (same day)

Short SPX Option Strike 1995 (Delta mid: -49%) Absolute value: 49%

Long SPX Option Strike 2005 (Delta mid: +41%) Absolute value: 41%

Sum of absolute value of delta: $49\% + 41\% = 90\%$

Sum of delta: $-49\% + 41\% = -8\%$

- 1) The 90% delta result is inaccurate as the maximum that can be lost in this trade is 10 points difference between the two strikes less the premium credit ($2005 - 1995 = 10$ points)
- 2) If SPX moves up by 1%, the 1995 call will move by 0.49% (delta adjusted), and the 2005 call will move by 0.41%. The net move against the trade -0.08% ($-0.49\% + .41\%$), which refers to delta of -8%

Multi leg trades on options are by nature a way to minimise risk and exposure to the underlying move. Adding absolute values together therefore inflates the leverage calculation and may mislead investors. For example a 10y IR Swap which if broken down as 5y + 5y by 5y IR swap doubles the exposure with no economic implication would be treated in the same way under the AIFMD leverage calculations as a 1yr vs 10 yr Swap which have different risks but the same notional value.

Concerns with the commitment method

The commitment method addresses some of the issues inherent in the gross method through the application of netting and hedging arrangements and the use of duration netting rules. Although this is an improvement on the gross method, the commitment method still suffers from a number of deficiencies, which include the following:



- **Intention at the time of the trade:** Under Article 8(3)(a) of the Level 2 Regulation, netting is only permitted under the commitment method where “trades on derivative instruments or security positions are concluded with the sole aim of eliminating the risks linked to positions taken through the other derivative instruments or security positions”. This is therefore dependent on the intention at the time of the trade, which is a subjective test. There has been no further guidance as to how this intention can be ascertained and determining when netting is permitted is therefore a matter of interpretation for each AIFM, which gives rise to uncertainty. It is therefore unclear what the conditions for permitted netting are;
- **Potential for excessive netting:** Article 8(3)(a) of the Level 2 Regulation also provides that netting is permitted across derivatives “which refer to the same underlying asset... irrespective of the maturity date”. This would therefore permit the netting of a very long term interest rate derivative (for example, a 30 year swap) with a short term interest rate derivative (for example, a 2 year swap), or a long-dated commodity derivative (for example, natural gas futures with 5 year maturity) with a short-dated commodity derivative (for example, Natural Gas futures for December 2014 maturity), in both cases leaving an exposure of zero. This leaves the potential for excessive netting which may mask real exposures;
- **Application of duration netting rules:** The Commitment Method permits “duration netting” under certain conditions. Article 8(9) of the Level 2 Regulation provides that “AIFMs managing AIFs that, in accordance with their core investment policy, primarily invest in interest rate derivatives shall make use of specific duration netting rules in order to take into account the correlation between the maturity segments of the interest rate curve as set out in Article 11.” In relation to this provision, Article 11 provides that

“The duration-netting rules shall not be used where they would lead to a misrepresentation of the risk profile of the AIF. AIFMs availing themselves of those netting rules shall not include other sources of risk such as volatility in their interest rate strategy. Consequently, interest rate arbitrage strategies shall not apply those netting rules... The use of those duration-netting rules shall not generate any unjustified level of leverage through investment in short-term positions. Short-dated interest rate derivatives shall not be the main source of performance for an AIF with medium duration which uses the duration netting rules.”

These tests lack clarity and determining whether duration netting rules may be applied, absent further guidance, is therefore a matter of interpretation for each AIFM, which gives rise to uncertainty;

- **Maturity range buckets:** It may also be possible for the duration netting rules to lead to excessive netting. The duration netting rules specify that interest rate derivatives should be allocated to one of four maturity range buckets: 0-2 year, 2-7 year, 7-15 year and >15 year. Within each bucket, 100% offset is allowed. This means that under these rules, for example, a 2 year swap can be netted with a 7 year swap, leaving an exposure of zero. This leaves potential for excessive duration netting and can mask real exposures. The use of the four maturity range buckets and the offset percentages is also an arbitrary choice and bears no relation to risk measurement. For example, a 2 year vs 7 year offset will be fully netted, while a 1.9 year vs 7.1 year offset will only be netted 25%, despite these spreads having almost identical risk;
- **Target duration:** The use of “target duration” introduces inconsistencies between AIFs as the duration netting rules specify that all interest rate derivatives should be subject to a duration adjustment. This adjustment must be made with respect to the AIF’s “target duration”, defined as being “in line with the investment strategy, the directional positions and the expected level of risk at any time”. In principle this will mean that each AIF may have its own “target duration” and therefore leverage numbers calculated using this rule will be inconsistent and not comparable between AIFs. Furthermore, hedge funds do not generally utilise a pre-defined “target duration” as part of the investment/trading process and therefore the required course of action for the AIFMs of such funds is unclear.



ESMA final advice

Due to the shortcomings of both the gross and commitment method, in its Final Advice to the Commission on AIFMD Level 2 measures in November 2011, ESMA advised the Commission to adopt an alternative measure of leverage.³⁵ ESMA noted that “the advanced method which relaxes the rules of the commitment method was designed for AIFMs managing AIFs for which the commitment method may not be appropriate or may not provide meaningful results.” However, the Commission rejected the adoption of ESMA’s proposed advanced method as they felt that it left too much discretion to the AIFM. In the Level 2 impact assessment, the Commission wrote that:

“the risk would be that many different methods coexisted which do not lend themselves to comparison with other funds or an aggregate view for supervisors. Therefore, it is doubtful if allowing for this additional method would contribute positively to the objectives of investor protection and proper supervision...”

The advanced method has the disadvantage that, even if it might produce most accurate information about the leverage of a particular AIF, these figures would not be comparable and could not be aggregated. Furthermore, there is a risk that the freedom in the design of the method would be used to produce artificially low leverage figures.”

Whilst the Commission noted that an additional measure may be helpful, it rejected the advanced method proposed by ESMA. We therefore suggest a method below which would not leave as much discretion to the AIFM as the method proposed by ESMA would, but which would generate a leverage figure which would be more comparable across the financial sector and more useful to investors.

Risk mitigation techniques

One aspect of effective risk management in AIF portfolios is the ability to hedge positions. Some leveraged strategies use derivatives for hedging purposes. Others, such as, for example, ‘relative value’ strategies may use long and short positions in similar instruments (e.g. two bonds issued by the same issuer) to hedge the risk instead of, or in combination with, derivatives.

Under the gross and commitment methods, these two risk mitigation approaches differ. Both positions would display the highly similar risk characteristics to the position holder; however, the AIFM’s choice of derivative versus short position in these circumstances could be dictated by a range of external factors. These include: (i) access to financing (i.e. a bond is a fully-funded instrument and a swap is not); (ii) access to executable swap markets; (iii) the availability of a functioning repo market in the relevant bond; (iv) exposure to counterparty credit risk (some sovereign bonds would be zero risk rated whereas, by contrast, OTC derivatives would always carry counterparty risk); (v) the ability to price positions (bonds are easily priced, as compared to some OTC derivatives); and (vi) margin considerations.

It is important to ensure that AIFMs remain free to use any tools available to them to manage the risks within AIF portfolios effectively without having regard to leverage ratios that favour one risk mitigation technique over another. Moreover, penalising one risk mitigation strategy in favour of another could potentially have adverse consequences for the effective functioning of EU markets at certain times. For example, a number of AIFMs might be forced to unwind their bond positions around the same time if they calculate their leverage at year-end.

In connection with the review of the leverage calculation methodologies envisioned by Article 6(2) of the Level 2 Regulation, we would therefore suggest that the gross and commitment methods are not “sufficient and appropriate for all types of AIFs”³⁶ and that an additional and optional method for calculating leverage should be developed.

³⁵ See pages 188-202 of the Final Advice.

³⁶ See Article 6(2) of the Level 2 Regulation.



The need for an alternative measure

We consider that there should be another measure of leverage which is based on a measure of exposure which is more aligned with what is deemed to be most appropriate by most investors, managers as well as regulators. Whilst we acknowledge that there is a real diversity of views as to what the appropriate calculation methodology for leverage is, the approach we suggest below would at least provide for a method of calculating leverage with which the financial sector, including investors, was more familiar. This new measure of leverage should be capable of being calculated in a fairly straightforward manner and not be subject to discretion from managers so that it can be implemented across a broad spectrum of strategies. Under the gross and commitment methods, there is still discretion from managers in certain elements of the calculation. In particular, the gross and commitment calculation methodologies leave scope for interpretation in relation to FX forwards and interest rate derivatives. Although this is not the purpose of this submission, we would welcome clarification on these ambiguities to allow for comparability among AIFs for both regulators and investors. For the reasons outlined below, AIMA believes that for portfolios containing derivatives leverage is an incomplete, inadequate and misleading measure of risk and therefore investors and regulators should be strongly advised to consider alternative information when making risk assessments.

Alternative measures of leverage

Leverage is usually calculated as a ratio of exposure/size of a portfolio of assets to the level of capital or equity that may support that. For funds, it is generally agreed that the fund's NAV is the best estimate of capital or equity. However, there is no agreement on what would constitute the best measure of exposure. This is mainly because there is little agreement on how to approach off-balance sheet exposures obtained via the use of derivatives.

Below, we have carried out a calculation of leverage using several approaches on a sample of real hedge fund portfolios. More importantly, we demonstrate below the ease with which a third measure of leverage (adapted from the calculation methodology in Basel III) which we propose can be easily obtained from the sample by simply classifying various derivatives exposures into predefined buckets and then applying risk weights to those exposures as per the table provided in the CRR (Article 274). We hope this demonstrates the practical feasibility of using this kind of measure as a more sophisticated and more risk sensitive measure of leverage for the asset management industry.

1. Analysis of various types of fund leverage:

There are three relevant types of leverage for purpose of this response.

(i) Financial leverage/Balance sheet leverage:

Fund leverage can be calculated in a number of ways. The first and arguably, the most recognised measure for calculating leverage is through the fund's balance sheet, taking the fund's gross value of assets controlled (i.e., total long positions plus short positions in their absolute terms) divided by its total capital or NAV of the fund.

(ii) Gross leverage:

Another method which can be used which, depending on certain detail, would use the full gross notional position arising from derivatives transactions in its measure of exposure (GNE), adding this measure to the size of the balance sheet and then dividing by the NAV.

In a simple example, if a futures contract is purchased on 100 shares of a stock trading at \$50 then the value for the off-balance sheet exposure used to calculate leverage would be \$5,000 ($\50×100).

(iii) Estimate of Basel III method of leverage:

Under this method, one can simply take the exposure measure to be the sum of the gross assets held by the fund and the adjusted GNE whereby the different derivatives asset classes are weighted by the factors indicated in Table 1 below.



Table 1: Risk weighted factors = from the table and we have applied the most conservative factor in each case.

Remaining Maturity	Int Rate	FX rate & Gold	Credit (Investment Grade)	Credit (non-investment grade)	Equity	Precious Metals (except Gold)	Other
<=1 year	0	0.01	0.05	0.1	0.06	0.07	0.1
>1 yr and <= 5 yrs	0.005	0.05	0.05	0.1	0.08	0.07	0.12
>5 yrs	0.015	0.075	0.05	0.1	0.1	0.08	0.15

Source: Conversion factor matrix for OTC derivative contracts for Basel III (Basel Capital Market Risk Final Rule)

2. Calculating hedge fund leverage on a sample of real hedge funds

We appreciate that it can be difficult to understand measures of leverage and risk without some data. To address this, AIMA has undertaken a study of a diverse sample of real-life hedge fund exposures to provide greater understanding of how the leverage ratio of funds varies dramatically depending on the exposure measure chosen for the leverage calculation. The AIMA study included analysis of 21 hedge funds of varying sizes and hedge fund strategies accounting for approximately \$60 billion in hedge fund assets under management and the over 88 thousand individual positions. The analysis was done in based on 31 March 2015 data and conducted with the help of MSCI RiskMetrics.

The study provides a unique analysis of hedge fund portfolios and attempts to estimate what the leverage measure of those portfolios would be if it were calculated in line with the measure of leverage adopted by the Basel III methodology, thus obtaining the most relevant comparison of risk to what is an internationally agreed methodology for measuring exposure arising from derivatives positions.

In demonstrating the extreme differences obtained around the measure of leverage depending on the exposure measure used, we present the following Table 2 (below) for consideration.

Table 2:

Measure	NAV	GAV	GNE	Adjusted Derivatives Exposures
Value (USD 000)	60,413,999	229,545,881	2,975,649,744	77,645,517

Source: AIMA/RiskMetrics, 2015

Key to this calculation

NAV = net asset value of the fund

GAV = gross asset value of the fund calculated as PV Total long + PV Total short positions (in their absolute terms) as reported in their reporting currency.

GNE = Gross Notional Exposure (GAV + notional value of derivatives positions)

Adjusted Derivatives Exposures = Notional value of derivatives positions x risk weighting from Table 1 (adaptation of the Basel III CEM approach).

(a) *Calculation of financial leverage (or balance sheet leverage).*

From Table 2, and with reference to the second and third columns, we provide the following:



GAV /NAV of the portfolio

$$\text{➤ } 229,545,881/60,413,999 = 3.8x$$

(b) *Calculation of gross leverage.*

As mentioned above, when calculating fund leverage using derivatives, it is suggested to do this by accounting for the fund's GNE, which is the absolute sum of all long and short positions including gross notional value (delta -adjusted when applicable) for derivatives. GNE does not directly represent an amount of money (or value) that is at risk of being lost. It is a reference figure used to calculate profits and losses. From Table 2, positions for GNE are reported as notional reporting currency.

The estimated fund leverage will be calculated using the formula provided below:

GNE /NAV of the Portfolio

And from Table 2 above, this equates to Total GNE/NAV of the portfolio:

$$\text{➤ } 2,975,649,744/60,413,999 = 49x$$

(c) *Use of the Basel III measure.*

If it is the intent to calculate size and leverage in a manner which is comparable to the banking industry and the broker/dealer sector, we suggest that one should use some form of a Basel III measure in calculating a fund's leverage. We have attempted to estimate the risk-weighted exposure of each underlying derivatives exposure and add this to the gross assets of the portfolio and then divide into the fund's balance sheet total.

Applying the risk factors in Table 1 to the various types of derivatives in the portfolio provides us with an estimate Basel III risk measure:

Applying the formula:

Gross assets + adjusted gross exposures/ NAV of the portfolio

$$\text{➤ } 229,545,881 + 77,645,517/60,413,999 = 5.08x$$

The sum of total adjusted gross exposures are calculated by multiplying out the gross notional exposure of the portfolio fund positions broken down by the relevant derivatives types by the most conservative of the various risk weights. This means we assume that the maturity of all the derivatives positions in the portfolio is greater than five years.

Summary of study results and conclusion

The measure of leverage for hedge funds varies significantly depending on the manner in which derivatives exposures are taken into account.

1. Simple financial leverage (GAV/NAV) - 3.8X
2. Gross method (GNE/NAV) - 49x
3. Basel III (AdjGNE/PV) - 5.08x

The gross method is shown as a very poor measure for calculating leverage, as it does not: (i) allow for the netting of positions that might decrease or eliminate risk in a portfolio, (ii) account for the relative risk of different types of derivatives positions held by a fund, and (iii) take account of the non-linear nature of the risks arising from options and other similar derivative positions.



The application of the adjusted Basel III method shows how the dominance of one particular type of derivative - interest rate swaps - creates an impression of excessive size and leverage of hedge fund portfolios when looked at on a gross basis. Applying the Basel III adjustments to the GNE measure of size results in a far more accurate figure for the size and leverage of the fund and the risk that it may pose to both investors and to the financial system.

It therefore appears that the GAV and a simple financial leverage is a better approximation of a size riskiness of a hedge fund portfolio than a measure of leverage based on GNE. This is corroborated by the application of the Basel III methodology to a sample of real life hedge fund data. We would therefore suggest that the Commission should develop a GAV and a simple financial leverage calculation methodology under the AIFMD which could be used by AIFMs as an additional measure which may present a more accurate figure for the level of leverage employed by the fund. We consider that this would not only be beneficial to investors, as it would aid them in making comparisons between funds employing different strategies and analysing the level of risk posed by a fund, but it would also aid national competent authorities in assessing the systemic risk of funds that trade in certain instruments which generate high levels of gross exposure.