

AIFM Directive: New changes on the horizon

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Upcoming review of the AIFM Directive

The AIFM Directive is, without doubt, a success story in terms of investment funds regulation. While that was not necessarily obvious at its inception in 2011, where in particular the shift from a product focused fund regulation to the supervision of fund managers raised some concerns, this has become quite clear nowadays. Luxembourg has embraced the new framework since its transposition into national law in 2013 and, building on its experience and infrastructure with UCITS, emerged as the first port of call for international initiators of alternative investment funds in Europe: EUR 778 billion of assets under management and over 4400 AIFs (source: EFAMA, Q1/2020) speak for themselves.

From the beginning, the AIFMD was intended to be evaluated by the European Commission (EC) after some time, in order to assess its impact on the industry and identify any areas for improvement. Pursuant to Article 69 of the directive, this process was supposed to take place by July 2017, and is currently expected to formally start in September this year. The delay is in no small part due to Brexit, as the main domicile of fund managers (by a large margin) becoming a third country with respect to the EU will have a significant impact on the financial industry as a whole and the investment funds world in particular.

Some preparatory work for this impending review has already been carried out over the past years: Such as the report, drafted by KPMG at the request of the EC and published at the end of 2018, on how the AIFMD has worked and has been perceived by the funds industry; more recently (in June 2020), the EC itself published an assessment report to the European Parliament and Council. It echoed the widespread perception that the directive has succeeded in creating an internal market for EU alternative funds and their managers by offering a high level of investor protection at the same time.

Latest development: ESMA letter to the European Commission

The latest contribution to this process comes from the European regulator ESMA, which summarised its perspective



view in a letter to the EC in August 2020. Its views are of particular interest as they are based on the experience of the national regulators that work closely with all market participants. ESMA, through its own guidelines and Q&A publications has shaped the practical implementation of the AIFMD to no small extent. The publication of the letter at this point in time is certainly no coincidence, the likely objective being to influence the EC and its view on the upcoming review, potentially also to address some warnings to the UK as to the consequences of Brexit in this context.

Evolution rather than revolution

The positive reception by market participants and the resulting economic success of the AIFMD will, that much can already be said with some certainty, make any fundamental change to its structure or operating model highly unlikely. This is also reflected in ESMA's letter which focuses on details, definitions and improvements to the reporting rules rather than introducing entirely new topics. The largest potential amendment, the introduction of the third country passport that would enable non-EU managers and funds to publicly distribute their products in the EU is not even mentioned. Since the biggest spoke in that wheel is the intention not to reward the UK for leaving by granting it the same passport as EU managers, this is unlikely to change for the foreseeable future. Another key topic, the depositary passport, is mentioned only in passing, with ESMA appearing to agree with the fund industry that there is little merit in pushing for its introduction.

The European regulator also seems to be opposed to allowing certain categories of retail investors access to AIFs (this is currently limited to local private placement regimes, if available): It argues that while this would be conceivable, any cross-border marketing should be limited to professional investors – which would not be a

meaningful improvement over the current situation.

Convergence with UCITS rules and tightening of the delegation rules

An incremental evolution is, however, also in the industry's interest due to the substantial investments it has made into complying with the current rulebook. There are a number of items on ESMA's wish list that should be highlighted, in particular those that may have an impact for the Luxembourg fund industry. The general request for more digitalisation is one of the last but certainly not the least of these, in particular where the communication between regulators and market participants is concerned and which in Luxembourg is already practiced by the CSSF to a large extent.

One of these is the request for greater convergence between the AIFMD and UCITS rules. While a differentiation in some areas is necessary due to the different type of investors that are targeted, in others this does not seem justified and only leads to greater costs without added value. Pursuant to ESMA, that concerns in particular the level of detail in the current legislation with respect to risk management, liquidity management and reporting, which should be harmonised. In most cases, this will mean that UCITS as the older set of rules should add the AIFMD provisions in this respect.

Another field where AIFMD rules were not applied consistently throughout the EU in both UCITS and AIFMD is the interplay with MiFID. More specifically, which additional services could be provided by AIFMs or UCITS management companies outside of their core functions, and when in such case MiFID rules could apply – such as the provision of investment advisory services, discretionary portfolio management or even acting as delegate of the portfolio management function.

The delegation rules appear to be another area of concern for ESMA. This is somewhat surprising as most of the current delegation rules have been practised for several decades (having been conceived by the UCITS directives originally) and have also been recognised by the EC as robust. The rather vague mention of operational and supervisory risks or regulatory arbitrage could dissimulate the more political issue of the UK opting for deregulation. While it is undoubtedly more complicated to ensure that the regulatory environment is comparable, it has so far been possible to create such a level playing field by requiring an equivalent regime of supervision in any non-EU country where a delegate manager resides. Whether the EU would like to grant the UK such equivalent status in future is likely to be more of

a political than a legal question. The fine line between a formal delegation resulting in the application of the AIFMD rules, and a mere outsourcing of supporting tasks is another item that raises questions in practice. Is asking a group entity to perform investment research or data analysis already a delegation of the portfolio management function? ESMA believes that more detailed rules in the AIFMD would help in making such distinctions.

White label platforms and secondment of staff

The issue of regulatory substance has always been closely related to delegation, as the latter should not reduce the AIFM to a letter box entity. Another topic raised by ESMA in this context is the business model of white label platforms that is often offered by Luxembourg service providers. It consists in establishing a fund or a sub-fund for a third-party client within an existing service provider framework, and usually delegating the portfolio management to such client. Useful in particular for smaller fund initiators that shy away from the costs connected to establishing an entire structure of their own, and often a stepping stone to the establishment of their own fund further down the line, ESMA sees significant risks for conflicts of interest and investor protection and would like to see stricter rules for this case.

ESMA has a similar request regarding the temporary secondment of staff from advisory firms to an AIFM, raising the question whether such import of expertise is in line with substance and delegation requirements.

Loan origination funds

Investing in debt instruments or granting loans has been an activity of investment funds for quite some time, but has gained more traction through balance sheet constraints for banks and the low interest rate environment. ESMA reiterates its view (already published in an opinion back in 2016) that more regulation is called for and, in particular, that such funds should only be of the closed-ended type. Considering, however, that the AIFMD is conceived as a regulation for managers and not funds, it appears doubtful for it to be the right place to add further provisions, should they be called for.

External valuers

One part of the AIFMD framework that did not work well in practice is the possibility to appoint an external valuer. Market participants considered the liability regime to be prohibitive, as a result of the risk that they would be responsible to the AIFM for any loss, even due to simple negligence. ESMA argues for limiting such liability to gross negligence only, which would be in

line with market practice for other services provided to investment funds. It does not, however, mention the introduction of the possibility to use internal and external valuers at the same time.

Leverage, liquidity management and reporting

More efficient cross-border measures in terms of investment funds' liquidity (or absence thereof), such as enabling regulators to suspend redemptions, for example in case of a market crisis due to the Corona pandemic, would also be welcome pursuant to ESMA.

Exchange of data between regulators and their subjects is also part of the background of the request to align the leverage reporting pursuant to AIFMD (and also UCITS) with the recommendations issued by IOSCO in December 2019, or to further harmonise the supervision in case of cross-border marketing of AIFs, or of branches of AIFMs established in other jurisdictions. No mention, however, is made of the fees levied by regulators for marketing notifications, where a level playing field could also be useful.

The proliferation of reporting requirements for AIFMs resulting from various sources (EMIR, SFTR, MiFIR to name but a few) leads ESMA to the logical conclusion that such reporting should be made more efficient and should in particular avoid any redundancies, while also making it simpler to review and consequently to act on it. In Annex II of its letter, the regulator proposes a substantial number of improvements that could be made for these purposes. It also suggests, however, to require even more details on the AIFs' assets, liabilities and counterparties to be reported, which appears to be contrary to the aforementioned approach and would again require substantial investments by market participants into their reporting infrastructure.

Conclusion and outlook

While it is not a given that the EC will include the topics mentioned by ESMA in its letter, it should nevertheless be a good indication of the direction of travel of the upcoming review process. The careful amendment of an environment that has proven it works well would seem the appropriate approach. While a tendency to require even more detailed regulation is probably natural for a regulator but may not be the most efficient solution, many of ESMA's proposals should increase the efficiency of the AIFMD.

The expected timeline for the review process should see the impact assessment being made early next year, and lead to a proposal for an amended directive towards the second or third quarter 2021.



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