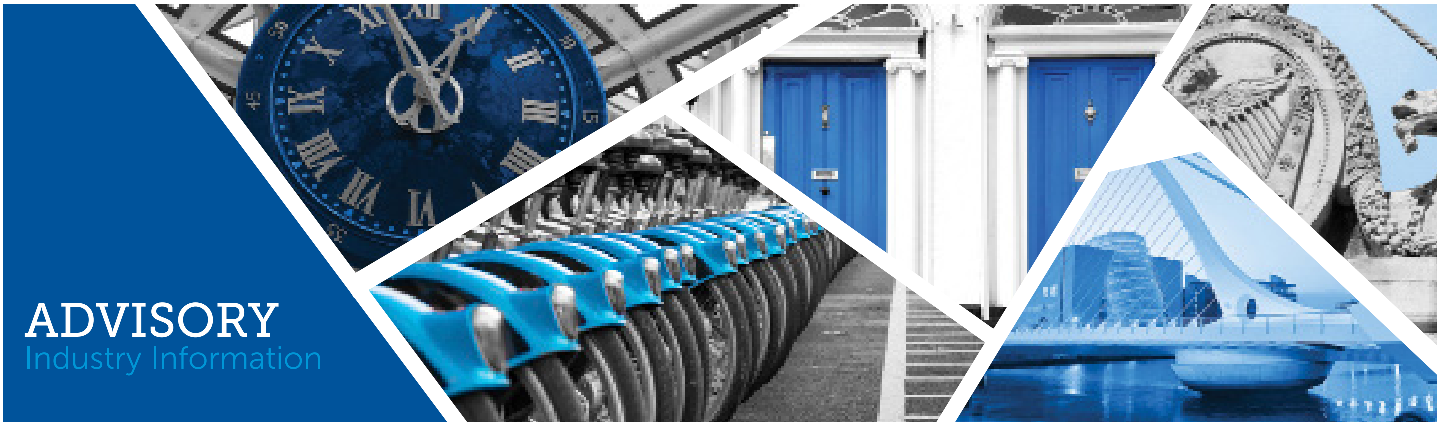

AIFMD – Room for improvement

August 2020

On 18 August 2020, the European Securities and Markets Authority ("**ESMA**") sent a letter to the European Commission (the "**Commission**") setting out suggested improvements to the Alternative Investment Fund Managers Directive ("**AIFMD**") for consideration as part of the Commission's current review of AIFMD. While the focus of the letter is on AIFMD, several suggestions also relate to amendments to the Undertakings for Collective Investment in Transferable Securities ("**UCITS**") framework.

Two annexes to the letter contain the detail of the suggestions being put forward by ESMA. Annex I sets out 19 key issues relating to the legislative framework where ESMA recommends amendments. Annex II sets out suggested amendments to the AIFMD reporting regime and use of data.

Harmonisation

The first matter raised by ESMA is greater harmonisation across the AIFMD and UCITS frameworks (the "**Frameworks**"), noting that generally the provisions of AIFMD and its level 2 measures[1] (the "**Level 2 Regulation**") are more granular or specific without any objective justification for such differences. Two specific examples provided are the requirements relating to risk management and liquidity management. It is also noted that the granularity of the Level 2 Regulation delegation provisions is not replicated in the UCITS framework.

On the theme of harmonisation ESMA also suggests that after improvements have been made to AIFMD Annex IV reporting requirements, harmonised UCITS reporting should generally be aligned with those requirements while allowing for such reporting to be tailored to the characteristics of UCITS. ESMA notes that AIFMD reporting data is being used by ESMA and the national competent authorities ("**NCAs**") to assess preparedness of investment funds in case of a new liquidity stress event. Such data is being used to: (i) identify alternative investment funds with large exposures to corporate debt and real estate markets; (ii) analyse the outflows, performances and use of liquidity management tools; and (iii) build a comprehensive assessment framework. However, ESMA notes that for UCITS ESMA does not have access to the same data and is therefore unable to apply the same approach. Separately, ESMA recommends clarification of the precise supervisory responsibilities of home and host supervisors in respect of certain cross-border marketing, management and delegation matters.

Delegation

ESMA recommends legislative clarification of the delegation and substance requirements not only for AIFMD but also for the UCITS framework. In this respect, five separate issues are raised by ESMA: (i) the extent of such delegation; (ii) the applicable regime in the case of delegation and regulatory arbitrage; (iii) the use of seconded staff; (iv) collective portfolio management functions and distinguishing these from "supporting tasks"; and (v) white label service providers.

i. Extent of delegation – ESMA suggests clarifying the maximum extent of delegation permissible under the Frameworks to ensure supervisory convergence and that authorised alternative investment fund managers ("**AIFMs**") and UCITS management companies ("**UCITS ManCos**") maintain sufficient substance in the EU.

ii. Regulatory arbitrage – ESMA recommends that to avoid regulatory arbitrage and protect EU investors, legislative amendments should be introduced which ensure that the management of AIFs and UCITS is subject to the regulatory standards set out in the Frameworks, irrespective of the regulatory license or location of the delegate.

1 Commission Delegated Regulation (EU) No 231/2013.

iii. Use of seconded staff – ESMA questions whether secondment arrangements are in line with the substance and delegation rules set out in the Frameworks and suggests that further legislative clarifications could be helpful to address this matter.

iv. Collective portfolio management functions – ESMA notes that in the absence of clear legal definitions or an exhaustive list of the collective portfolio management functions set out in Annex I of AIFMD and Annex II of the UCITS Directive, it is often difficult for NCAs to assess whether "supporting tasks" provided by group entities on the AIFM or UCITS ManCo are subject to the delegation rules set out in AIFMD and UCITS Directive or not. ESMA suggests clarifying this issue in line with the interpretation supported by ESMA in Section VIII of its AIFMD Q&As.

v. White label service providers – being fund managers that provide a platform to business partners by setting up funds at the initiative of the latter and typically delegating investment management functions to those initiators/business partners or appointing them as investment advisers or informally following their guidance/instructions. ESMA notes that specific regulatory provisions relating to this type of arrangement would be advisable.

Liquidity management tools

ESMA recommends that the availability of additional liquidity management tools be consistent across the EU and that AIFMD and the UCITS Directive be updated to reflect this. Such tools are those that that assist open-ended alternative investment funds and UCITS as well as their managers with managing requests for redemption appropriately and effectively at all times and especially in stressed market conditions and include post-event measures such as suspensions of redemptions or deferred redemptions (redemption gates/extendable notice periods) and pre-emptive measures such as the allocation of trading costs to subscribing/redeeming investors (swing pricing/anti-dilution levies).

Leverage

ESMA suggests two specific amendments relating to leverage. The first relates to the gross notional exposure method of calculating leverage and amending the current reporting requirements set out in the Level 2 Regulation to ensure alignment with a recommendation made by the International Organization of Securities Commissions in its recommendations for a framework assessing leverage in investment funds to employ a two-step approach. The second relates to amending the commitment amount calculation by adjusting the notional amounts of interest rate derivatives contracts by the duration of the ten-year bond equivalent. ESMA notes that this adjustment allows for comparisons among contracts with different underlying duration which is useful for systemic risk monitoring purposes. ESMA also notes that this should also be considered in the context of UCITS reporting.

Scope of MiFID activities

ESMA recommends legislative clarification on the scope of Markets in Financial Instruments Directive ("**MiFID**") activities that can be undertaken by AIFMs and UCITS ManCos as there is divergence between member states as a result of interpretative issues. ESMA also recommends greater regulatory consistency between the AIFMD, MiFID and UCITS frameworks to ensure that entities providing similar types of services are subject to similar regulatory standards.

AIFMD reporting regime

ESMA's proposed changes to AIFMD's reporting regime and data use relate to:

i. the obligation to acquire an LEI for the manager and its funds;

ii. the composition of assets and liabilities of the fund;

iii. the definition of leveraged fund;

iv. the scope of entities on the ESMA register and the timeline for the NCAs to update this register;

v. reporting in percentages;

vi. restrictions on the use and publication of the reported data;

vii. a proposed delegated act on reporting;

viii. reporting exemptions for Private Equity funds;

ix. a requirement to report ESG metrics; and

x. a European mandate for ESMA and ESRB to analyse systemic risks.

Other recommendations

ESMA's other recommendations include:

i. a specific framework for loan origination under AIFMD;

ii. changes to the depositary delegation rules in the Frameworks to allow depositaries not to apply the delegation rules to central securities depositaries ("CSDs") in their capacity as issuer CSDs but to apply these rules to CSDs in their capacity as investor CSDs;

iii. clarification of the application of the proportionality principle to the remuneration requirements in AIFMD and the UCITS Directive;

iv. clarification of the power of member states to apply additional national requirements in respect of sub-threshold AIFMs;

v. limiting the definition of negligence in respect of external valuation services to gross negligence;

vi. amendments to certain definitions in AIFMD and consideration of new categories of investors under AIFMD;

vii. clarification of the concept of reverse solicitation;

viii. convergence between AIFMD and the UCITS Directive on the treatment of significant influence over the management of an issuing body;

ix. allowing more digital communications; and

x. a study of the benefits and risks relating to a depositary passport.

Only time will tell what, if any, of the recommendations set out above will be adopted by the Commission as part of its AIFMD review and any future updates to the UCITS framework. However, the asset management industry will be following developments closely given the significant implications that lie ahead if some of these proposals are to be implemented.

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