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ESMA identifies issues for AIFMD review

On 19 August 2020, in a letter to the European Commission, the European Securities and Markets Authority (ESMA) published recommendations for the forthcoming review of Directive 2011/61/EU (the Alternative Investment Fund Managers Directive or AIFMD). The proposals, which cover a wide range of both fundamental and rather technical issues, also extend to Directive 2009/65/EC (UCITSD) and Directive 2014/65/EU (Market in Financial Instruments Directive II, MiFID II).

The AIFMD review is envisaged by article 69 of the AIFMD, under which the Commission is to review the application of the scope of the directive with a view to analysing the experience acquired in applying the directive as well as its impact on investors, AIFs and AIFMs in the EU and third countries. If appropriate, the Commission shall propose amendments to the AIFMD, although it has not yet done so. ESMA is now taking a clear position that amendments are required.

ESMA's letter comes after the Commission's report to the European Parliament and the Council assessing the application and the scope of AIFMD, which was published on 10 June 2020 ('the Commission report'), along with a corresponding staff working document (SWD). The Commission report and SWD were mainly based on a survey conducted by KPMG on the operation of the AIFMD, which was submitted on 10 December 2018 to the Commission ('the KPMG report').

The letter includes recommendations for changes in no less than 19 areas. Although the word 'Brexit' appears only once in the letter, the regulation of cross-border activities from a non-EU jurisdiction is a major and overarching topic of ESMA's recommendations.

Throughout the letter, ESMA also stresses the importance of achieving a level playing-field for managers of funds across the EU Member States. Furthermore, ESMA recommends aligning the two frameworks established by the UCITSD and the AIFMD where this appears appropriate.

In particular, ESMA mentions a lack of level 2 legislation in the UCITSD framework. This is something that national legislators have also identified. For example, the German legislator has applied many of the AIFMD level 2 rules to UCITSD management companies.

Finally, under the less prominent title 'amendments to definitions', ESMA proposes to clarify and/or define a number of important terms that could have a significant impact on the scope of application of the AIFMD.

Below, we summarise and analyse ESMA's most relevant recommendations in terms of their potential impact on the fund industry in Europe. We have not specifically included some of ESMA's suggestions where they are of a rather technical or generic nature, such as a harmonised reporting regime for UCITSD management companies, ensuring the proportionality of remuneration requirements and the AIFMD reporting regime and data use.

A. ESMA's recommendations

I. Amendments to definitions

ESMA notes that the definitions in article 4 of the AIFMD could be amended to clarify the scope of the AIFMD. In ESMA's view, the current definitions are too vague. Specifically, ESMA sees merit in further defining the central term of 'alternative investment fund' (AIF) in the level 1 text in line with its 2013 guidelines on key concepts of the AIFMD.

AIFs are currently defined as collective investment undertakings that raise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors and who do not require authorisation under the UCITSD. ESMA proposes to add definitions of "general commercial or industrial purpose in connection with real estate projects"; "pooled return"; and "investment policy".

As these terms were further explained in ESMA's 2013 guidelines, ESMA's proposal suggests incorporating these definitions in the level 1 text, rather than giving additional guidance on application of the scope. In further discussions, further guidance could extend to questions such as the treatment of blind pool concepts or single asset funds.

ESMA further notes that there should be clear rules indicating when issuers of certificates and crypto assets may qualify as AIFs and proposes to specify the distinction between holding companies and private equity funds, as well as to clarify the definition of joint ventures.

ESMA's proposal to clarify certain definitions in the AIFMD is certainly laudable given the directive's potentially broad scope of application. However, it may well not be sufficient to simply incorporate its guidelines on key concepts in order to create further clarity, given that all Member States have declared their compliance with these guidelines. Accordingly, further specifications would appear helpful.

ESMA's proposal to specify the distinction between (unregulated) holding companies and PE funds (which fall within the scope of the AIFMD) is interesting, as differentiating between both is frequently difficult in practice. Again, however, ESMA does not indicate at this stage what further specifications may look like.

In the UK, the Financial Conduct Authority (FCA) has published guidance on its views on the scope of the holding company exclusion, which references and builds upon guidance issued in the European Commission's Q&As. Whilst there will always be a need to consider the specific facts, generally the FCA guidance is considered helpful to the question of whether or not the structure is an AIF. The German Federal Financial Supervisory Authority (BaFin) and the French Autorité des marchés financiers (AMF), however, have not offered similar guidance, as a consequence of which the distinction between holding companies and PE funds is not entirely clear in France and Germany.

With regard to PE funds, the AIFMD contains various definitions and specific concepts that could also benefit from additional clarification, such as the transparency requirements in case of acquisitions of control and the rules on asset stripping. This point was raised in the Commission's report, which noted that it was not possible to establish their added value. Although this was apparently due to a lack of data (which is noteworthy given the extensive KPMG report, which covers articles 26 to 30 AIFMD extensively), the finding begs the question whether either the rules should be reformed to make them clearer and more efficient or it would be better to repeal the provisions.

II. Delegation and substance

One central issue in ESMA's proposals is the rules on delegation, which ESMA proposes to clarify both in the AIFMD and UCITSD. It is interesting to note that the Commission report does not address this issue at all, whereas the SWD concludes that the 'AIFMD rules regarding delegation arrangements are proportionate within the imposed limitations' and does not identify any need for change.

Perhaps unsurprisingly, many of ESMA's proposals appear to be Brexit-driven. ESMA itself refers to its opinion to support supervisory convergence in the area of investment management in the context of the United Kingdom withdrawing from the European Union in this context. The impact of ESMA's proposals with regard to delegation and substance requirements would, however, not only be felt in the UK, but also could have a significant impact on the fund industry in the EU27 as a whole and in other third countries where non-EU managers take delegation from EU management companies.

1. Extent of delegation

With regard to the permissible extent of delegation, ESMA notes that the extensive use of delegation by AIFMs and UCITS management companies may result in situations where the majority of the manager's human and technical resources are provided by (non-EU) third parties. ESMA proposes, therefore, to further clarify the extent to which managers may delegate functions to ensure supervisory convergence and sufficient substance of EU AIFMs and UCITS management companies. In particular, ESMA proposes to review article 82 of the AIFMD Commission Delegated Regulation (EU) No. 231/2013 and to either introduce quantitative criteria or provide a list of critical functions that cannot be delegated.

Article 82 already provides certain qualitative criteria with regard to the permissible extent of delegation, which are more detailed than rules applicable to banks delegating relevant functions, even though the ECB/SSM has,

particularly in the context of Brexit, interpreted the rules broadly to restrict the use of arrangements that it considered to lead to 'empty shells' (see, for example, the ECB's supervisory expectations on booking models). This highlights that the extent of permissible delegation continues to be particularly relevant for European regulators.

Moreover, it is unclear to what extent ESMA proposes to use quantitative criteria, and what quantitative criteria would look like. In particular, it is doubtful whether reliable metrics exist that would make it possible to quantify the 'amount of delegation' of specific activities in order to enable market participants and authorities to distinguish permissible from impermissible outsourcings.

2. Applicable regime in case of delegation and regulatory arbitrage

Regarding the applicable regime in case of delegation and regulatory arbitrage, ESMA notes that amendments to the AIFMD and UCITSD should ensure that the management of AIFs and UCITS is subject to the same regulatory standards, irrespective of the licence or location of the delegate.

Delegation of functions helps the investment management industry to ensure that management structures and expertise benefit investors. A level playing field may help to reduce inefficiencies due to divergent administrative practices among national competent authorities. While retention of core functions within a regulated and supervised entity is a legitimate concern, the revised rules must not unnecessarily hinder efficient organisational set-ups and access to global expertise.

3. Use of seconded staff

ESMA wants to address the use of staff seconded to AIFMs and UCITS management companies. The authority notes the increasing use of secondment agreements that could, in its view and in some cases, raise questions around the substance requirements and delegation rules in the AIFMD and UCITSD. According to ESMA, the legislative framework regarding the use of seconded staff could, therefore, be clarified.

ESMA did not address the use of seconded staff in its July 2017 Brexit opinion. However, the ECB expects – without indicating a legal basis – that secondments of members of the management body, key function holders and staff employed by banks under its supervision should be an exception and only occur in 'duly justified cases'. The ECB also expects that staff seconded to a bank who spend more than 50 per cent of their time working for the bank should be employed by that bank.

While ESMA's suggestions appear to be in line with this general trend, it is doubtful whether granular rules on secondments are really required. The duty to establish a proper business organisation already appears to allow authorities to act in clear cases of improper use of secondment arrangements.

4. List of collective portfolio management functions and distinction from 'supporting tasks'

ESMA proposes to reduce any legal uncertainty with regard to the responsibilities of AIFMs to ensure that the collective portfolio management functions set out in annex I of the AIFMD are performed in compliance with AIFMD rules.

ESMA notes that group entities within or outside of the EU often provide what is labelled 'supporting tasks' (such as administrative or technical functions) that generally are not subject to AIFMD delegation rules to the authorised AIFM or UCITS management company. ESMA queries whether tasks characterised as purely supporting are in fact supporting in nature at all times.

Due to a lack of a clear legal definition or an exhaustive list of collective portfolio management functions, ESMA considers it difficult to assess whether or not a specific activity is subject to the delegation rules set out in the AIFMD and UCITSD. Against this backdrop, ESMA sees merit in implementing legislative clarifications in line with its Q&A on the application of the AIFMD.

However, regulatory guidance on the distinction between tasks to which the delegation regime applies and mere 'supporting tasks' is already much more detailed in the AIFMD than the comparable regime for banks and investment firms, which only provides that activities are delegated or outsourced (and outsourcing rules are hence applicable) if the relevant institution would otherwise undertake the activities itself. Annex I of the AIFMD, on the other hand, already lists specific activities to which the outsourcing regime clearly applies. The comparison to the rules applicable to banks and investment firms suggests that ESMA, in fact, intends to not only clarify the current framework but also tighten the existing rules.

5. White-label service providers

With its fifth recommendation in relation to delegation and substance, ESMA addresses the business model of management companies providing white-label services. ESMA notes that some national competent authorities (NCAs) are unsure whether this business model is in line with the AIFMD and UCITSD, although such concerns are not further specified.

White-label service providers (WLSPs) are firms that provide a platform to business partners by setting up funds at the initiative of the partner and delegate investment management functions to such partners (or their partners) or appoint them as investment advisers. ESMA notes that if the Commission permitted such business models, then more specific regulatory provisions would be advisable. In particular, ESMA proposes to reduce the

'distinct and significant conflicts of interest and investor protection risks faced in these cases'.

ESMA's WLSP proposal and its strong wording come as a surprise. As ESMA itself notes, WLSPs have been active in the market for many years. In particular, they have closely aligned their business models with applicable regulatory requirements (including requirements on the management of conflicts in delegation scenarios).

In interpreting article 82 of the AIFMD Delegated Regulation No. 231/2013, Germany's financial regulator BaFin, for example, has considered for years that portfolio management functions may be outsourced in their entirety as long as risk management functions continue to be entirely performed by the management company. In France, the AMF's position is that the overall importance of delegated functions cannot exceed that of retained functions, although this has not prevented the creation of WLSPs in France.

In the UK, delegation of portfolio management functions and "hosting" arrangements are permitted although we note that against the backdrop of the Woodford case cited by ESMA, which involved the collapse of a UK-based fund due to a lack of sufficiently liquid assets, the FCA has stated that it is reviewing how effectively "host" managers undertake their responsibilities, in particular in relation to appointed representative and secondment arrangements.

By contrast, ESMA's comments on WLSPs could now be read as if ESMA questioned this balanced supervisory approach. Given that WLSPs play such a crucial role, particularly for institutional investors, and that such models have existed for many years, it would be wise to clarify that such business models are permissible rather than restricting their application.

Exceptions to that rule (like the Woodford case) should serve as a reminder to exercise appropriate supervision, but not serve as an excuse to restrict a market-standard and tested business model.

III. Reverse solicitation

ESMA proposes to clarify the definition of and rules for reverse solicitation, which, according to ESMA, is vital in facilitating cross-border distribution of collective investment undertakings. Due to a lack of a clear definition and rules, the framework for reverse solicitation is currently subject to divergent practices and interpretations by the NCAs.

While recital 70 refers to the concept, the AIFMD does not mention reverse solicitation explicitly. The recital says that the AIFMD should not affect the current situation, whereby a professional investor established in the Union may invest in AIFs on its own initiative, irrespective of where the AIFM and/or the AIF is established. Recital 70, therefore, follows a narrow approach with regard to possible types of investors that may be serviced on the basis of reverse solicitation.

Similarly, the UCITSD does not mention the concept of reverse solicitation at all. In Germany, however, the concept of reverse solicitation applies to professional and semi-professional investors in respect of AIFs and UCITS (section 293(1), sentence 3 of KAGB). Likewise, in France it can be relied on in respect of any type of investor and in the UK, reverse solicitation can potentially be relied on in respect of any offering or placement of interests in an AIF.

When reforming the framework for reverse solicitation, ESMA and the Commission may seek inspiration in MiFID II, article 42 of which provides that reverse solicitation applies to retail and professional clients. The reverse solicitation framework in MiFID II and ESMA's Q&A on investor protection provide a tested reference for the AIFMD review. The importance of a clear and reliable framework for reverse solicitation is evident, in particular if the UK and the EU do not reach an agreement on their future relationship in relation to financial services. Any change in rules should take into account that reverse solicitation is a tested concept allowing (professional) investors in the EU to access attractive investment opportunities offered elsewhere.

IV. Semi-professional investors

ESMA appears supportive of the introduction of a new category of 'semi-professional investors' in the AIFMD, provided that it is accompanied by appropriate investor protection rules and that passporting activities are limited to the marketing to professional investors.

The concept of 'semi-professional investor' is not new. In fact, the category was introduced to the KAGB in 2013 in an attempt to actually grandfather existing investments for what was called institutional investors after the switch from the former German Investment Act (*Investmentgesetz* or InvG) to the new KAGB. The term 'semi-professional investor' (section 1(33) of KAGB) is defined broadly and includes high-net worth individuals, federal and municipal entities, as well as experienced members of the financial industry.

The KAGB treats 'semi-professional investors' and 'professional investors' as equals in many respects. In particular, section 1(6) no. 2 of KAGB provides that only 'professional investors' and 'semi-professional investors' may purchase units in 'Spezial-AIF', which account for the overwhelming majority of AIFs in Germany (see 'Importance of Spezialfonds' in EMSA's 2020 annual statistical report on EU AIFs). Similarly, in France, certain AIFs that are not regarded as 'retail' funds may accept retail investors who meet a minimum investment condition (typically €100.000) and/or can show sufficient knowledge of the relevant type of funds or of their underlying assets. In the UK, unauthorised funds may be pro-

moted to certain categories of retail investors such as high-net worth individuals and sophisticated investors.

Introducing the category of 'semi-professional investors' in the AIFMD may have a far-reaching impact on those jurisdictions that already have a regulatory regime for this group, in particular with regard to existing agreements. It therefore seems advisable to consider the impact on national legislation, such as section 1(33) of KAGB, when planning the introduction of the category into the directive.

V. Harmonisation of supervision of cross-border entities

ESMA notes that there is still a lack of clarity around the responsibilities of home and host regulators in cross-border marketing, management and delegation cases. Reducing uncertainty would benefit the capital markets union, so EMSA suggests providing further clarification regarding the supervision of cross-border activities of UCITS management companies and AIFs, their managers and delegates.

In particular, ESMA notes that the Commission should provide guidance on the depth of the analysis by NCAs under the marketing passport in article 32 of the AIFMD. ESMA also proposes to further clarify home and host NCA rules in cross-border cases under the management passport in article 33 of the AIFMD and to harmonise the rules around branch supervision.

VI. Loan origination in AIFMD

Following up on its 2016 recommendations, ESMA notes that there should be a specific framework for loan origination within the AIFMD. The ESMA opinion contains recommendations on authorisation for loan-origination funds, types of funds (closed-ended vehicles), admitted investors (complying with ELTIF rules), and organisational and prudential requirements for loan-origination funds (e.g. leverage, liquidity, stress testing, reporting, diversification, etc).

In general, the proposal to establish a clearer framework for loan-origination funds is laudable. It also echoes the SWD's conclusion that there are differing national rules for AIFs providing non-bank finance and that it may be worthwhile considering an EU-wide approach to AIFs issuing loans given their increasing importance for the real economy and financial stability. However, despite the importance of a harmonised regime for loan-origination funds, ESMA does not provide any new proposals as to the scope and contents of any new rules. Instead it points to its opinion from 2016, which proposed to create a level playing field for debt funds. Four years on, such a level playing field still does not exist.

In order to be able to continue to grow across the EU, the loan fund industry has to be able to rely on a harmonised regime. While certain EU jurisdictions have a restrictive regime either comparable to the regulation of banks (the KAMaRisk in Germany for example) or that provides for specific conditions that AIFs wishing to lend money and their AIFMs must meet (see AMF Instruction 2016-02 in France, for example), the UK and other EU Member States, such as Luxembourg and Ireland, provide for more flexibility. For example, there is no specific regime for loan funds in the UK and loan origination activities are not subject to regulatory requirements. While funds from these jurisdictions are free to offer loans in Germany under the EU passport, German funds are thus put at a disadvantage. For German market participants, efforts to level national differences in regulation are certainly welcome, given that the German legislation has arguably caused German market participants to set up loan originating funds in Luxembourg or Ireland rather than in Germany.

When refining rules for loan-origination funds, lawmakers should consider that risks associated with loan origination by funds (which largely rely on equity capital contributions) is different from banks that take in deposits. This route has, for instance, been chosen by France when introducing a specific regime allowing certain French AIFs to undertake lending business. Until today, the potential for investment funds to make up shortfalls in the lending market has not been fully unlocked.

Moreover, there have been a number of significant market developments since ESMA's 2016 opinion, which could have been reflected in the letter. Most importantly, the importance of this business model has continued to grow over recent years with double-digit annual growth rates. The COVID-19 crisis will likely contribute to the growing importance of loan-origination funds.

VII. Scope of additional MiFID services and application of rules

With regard to the scope of MiFID services that can be provided by AIFMs and UCITS management companies, as well as the application of MiFID rules, ESMA provides an array of proposals.

Due to diverging views across Member States, ESMA proposes to clarify the scope of permissible business activities listed in article 6(4) of the AIFMD and article 6(3) of the UCITSD in conjunction with annex I of the AIFMD and annex II of the UCITSD, in particular with regard to activities that are not listed in these provisions.

Furthermore, ESMA proposes to clarify whether MiFID rules apply when providing services under article 6(4) of the AIFMD and article 6(3) of the UCITSD, in particular with regard to discretionary portfolio management or investment advice on assets that do not qualify as financial instruments, such as real estate.

Similar uncertainty exists where investment management functions for an AIF/UCITS are performed on a delegation basis. ESMA proposes to clarify the AIFMD, UCITSD

and MiFID frameworks to ensure that AIFs/UCITS and their managers and MiFID investment firms always remain subject to the same regulatory standards while providing the same type of services.

Moreover, ESMA notes that entities providing similar types of services, such as marketing, should also be subject to similar regulatory standards.

Finally, ESMA proposes to update references in the UCITSD and AIFMD to MiFID II and MiFIR. This would not be just a formal exercise but, for example, also extend the scope of transaction-reporting obligations under article 26 of the MiFIR to AIFMs and UCITS management companies.

In general, ESMA's efforts to increase the clarity of the regulatory framework for managers that also provide MiFID services are welcome. In particular, it is not always clear how MiFID and AIFMD/UCITSD rules interact in a delegation context.

However, when working out relevant clarifications, any overlap of the rules should be avoided. Service providers in the asset-management sector in particular should not be required to observe both AIFMD and MiFID rules, at least where they diverge. Rather, the EU should work on alignments of those rules in order to avoid an inefficient regulatory framework that does not add value to investor protection.

VIII. Availability of additional liquidity management tools

ESMA believes that the availability of liquidity management tools (LMTs) for managers should be consistent throughout the EU. As stated by ESMA, the on-going COVID-19 crisis shows that LMTs should be available in all jurisdictions in a consistent manner. Similarly, the availability of all LMTs should also be extended to the UCITSD.

ESMA's proposals directly reflect the recommendations of the European Systemic Risk Board (ESRB) of 7 December 2017 on liquidity and leverage risks in investment funds ('the ESRB recommendations').

Effective since 28 March 2020, the German legislator has already added three new LMTs to the set of tools available to certain types of funds – i.e. redemption periods, redemption gates and swing pricing – in an effort to promote Germany as a location for funds and management companies. While the introduction of these measures seems to be mainly COVID-19 related, there is no indication that these additional liquidity management tools would only be applicable for a limited period of time. Similarly, in France, the AMF started introducing LMTs as early as 2018 and relaxed some of the associated requirements in the context of its COVID-19 relief measures. In the UK, a range of LMTs are available to managers and in September 2019, the FCA introduced new liquidity risk management rules for non-UCITS open-ended funds investing in inherently illiquid assets.

IX. Depositary passport

With its last proposal, ESMA addresses the possible introduction of a depositary passport, an issue that has been ongoing since the UCITS II debate in 1993. Recital 36 of the AIFMD also invites the Commission to examine the possibilities of putting forward a proposal that, amongst others, clarifies the right of a depositary in one Member State to provide its services in another Member State. In the SWD, the Commission notes that it had brought forward twice the idea of a depositary passport; both proposals had been rejected by the co-legislators.

While ESMA does not explicitly recommend that depositary passports are introduced, it suggests that the Commission may (again) study the benefits and risks of such a passport.

In general, a depositary passport seems to be a useful tool, in particular for smaller markets, where the choice of depositary is very limited. However, the KPMG report found that only a small (but unspecified) number of interviewed AIFMs were actually in favour of introducing a depositary passport.

B. Conclusion

Overall, ESMA's proposals to provide more clarity to the AIFMD and UCITSD, to promote a level playing field between EU Member States and to harmonise, where appropriate, rules applicable to AIFMs and to UCITS management companies are helpful. It is also commendable that ESMA addresses many aspects that are relevant to the industry.

However, ESMA's letter touches a number of important and complex issues that will require further thorough analysis in order to identify suitable legislative measures. While Brexit may have absorbed capacities and thereby slowed down the development of the legal frameworks in the asset management sector, it now appears a good time to take up again the important matters for which ESMA had already made recommendations in the past, notably on the regulation of loan-origination funds.

In other fields, ESMA's suggestions risk overshooting where a reasonable approach with a sense of proportionality might be preferable. This is particularly true for white-label asset managers.

Finally, it would have been interesting to know ESMA's thoughts on future-proofing the AIFMD and UCITSD, for instance in the light of increasing digitisation of fund marketing, but also new asset classes such as crypto assets. ESMA could have explored the extent to which AIFMs and UCITS management companies may be able to rely on AI, automation, big data and robo advice, especially since the Commission has addressed these issues to some extent in the SWD.

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