# ESMA Recommendations on the Review of the AIFMD

Under the provisions of the Alternative Investment Fund Managers Directive ("**AIFMD**"), the European Commission ("**Commission**") was required to commence a review of the application and scope of the AIFMD in July 2017. It has published two reports to date as part of this review: a report on the operation of the AIFMD in January 2019 and an 11-page report setting out its preliminary thoughts in June 2020. The June report is light on detail and it is more likely that the Commission's consultation paper, expected before the end of this year, will provide a greater insight on the direction of travel of the review.

On 19 August 2020, ESMA sent a letter to the Commission highlighting 19 key areas to consider during the Commission's forthcoming review of the AIFMD. While the letter has been provided to the Commission in the context of the AIFMD review, it is noteworthy that many of the recommendations will also impact the UCITS Directive.

## Delegation and Substance

Perhaps of most significance, and drawing notable industry attention, are ESMA's recommendations in relation to delegation and substance. ESMA has suggested that legislative clarifications in the UCITS Directive and AIFMD frameworks could be provided in line with the ESMA opinion on supervisory convergence in the area of investment management in the context of the UK withdrawing from the EU. ESMA notes that, in light of the withdrawal of the UK from the EU, delegation of portfolio management functions to non-EU entities is likely to increase further.

ESMA observes that, in many cases, "*... extensive delegation arrangements may result in a situation where the majority of the human and technical resources (eg, IT systems) needed for the day-to-day operations are maintained by several third parties or even a single third party, potentially outside the EU.*" It is acknowledged that such extensive delegation may "*increase efficiencies*" and "*ensure access to additional expertise*" but ESMA states that it may also "*increase operational and supervisory risks*" and raise questions as to whether those AIFs and UCITS can still be effectively managed by the authorised AIFM or UCITS management company.

ESMA sees merit in reviewing article 82 of the AIFMD level 2 regulation, saying that the Commission may wish to reconsider and / or complement the qualitative criteria set out in that article with clear quantitative criteria or to provide a list of core critical functions that must always be performed internally and may not be delegated to third parties. ESMA states that these considerations would also apply to the UCITS Directive. According to ESMA,

> "*To avoid regulatory arbitrage and protect EU investors, legislative amendments should ensure that the management of AIFs and UCITS is subject to regulatory standards set out in the AIFMD and UCITS frameworks, irrespective of the regulatory licence or location of the delegate.*"

Noting the practice of seconding staff from professional services firms / consultancies or group entities to the AIFM or UCITS management company, particularly where secondees continue to work from their usual offices outside of the EU on a secondment rather than a delegation basis, ESMA states that this raises questions whether the arrangements are in line with the substance and delegation rules. It invites further legislative clarification on this issue.

ESMA also recommends legislative amendments to provide more granular detail as to the Annex I AIFM functions and Annex II UCITS Directive functions to assist in assessing whether group entities are providing "supporting tasks" to the authorised AIFM / UCITS management company or collective portfolio management functions subject to the delegation regimes.

## White-label Service Providers / Third Party Management Companies

The letter recommends that more specific requirements on white-label service providers (typically referred to as third party management companies) be provided to address the "*distinct and significant conflicts of interest and investor protection risks faced in these cases*". These conflicts arise, according to ESMA, due to the fact that the promoter of the white-label funds is also the client of the authorised AIFM / UCITS management company and may therefore decide to replace the AIFM / UCITS management company with another white-label service provider. In ESMA's view, "*... the authorised AIFM or UCITS management company will face significant conflicts of interest since controlling and challenging the delegate / investment adviser in the best interests of investors may come at the risk of losing a client / business partner and therefore losing its own revenue / management fees*".

## Scope of Additional MiFID Services

ESMA observes that the list of permissible activities of AIFMs and UCITS management companies in some member states (often referred to as "MiFID top-up services") is broader than others due to interpretational issues surrounding article 6(4) AIFMD, article 6(3) UCITS Directive and Annex I of MiFID. There are differing views with respect to whether investment management functions performed on a delegation basis constituted discretionary portfolio management or not and, consequently, whether MiFID or AIFMD / UCITS rules applied. ESMA calls for legal clarification around the application of the rules. ESMA also highlights the importance of ensuring 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.

## Harmonisation of the AIFMD and UCITS Regimes

ESMA notes that, in some cases, the AIFMD provisions are more granular compared to UCITS requirements eg, there are different levels of granularity with respect to risk management and liquidity management requirements and there are no detailed level 2 measures under the UCITS Directive in relation to delegation. UCITS management companies should be subject to similar reporting requirements as AIFMs to ensure that supervisors can accurately monitor systemic risks.

## Reporting Regime and Data Use

Annex II to the letter sets out ESMA's views regarding amendments to the AIFMD reporting regime and data use. ESMA suggests that the reporting template should be updated to provide greater alignment with other reporting frameworks (eg, MiFIR, EMIR, SFTR, ECB statistics on funds). This would allow AIFMs to reuse the same internal data to report under different regimes.

ESMA states that the AIFMD review is a very good opportunity to add ESG factors in the reporting to increase transparency regarding environmental impacts and consider social and governance aspects in line with the Commission's action plan on sustainable finance.

Further Recommendations

The letter includes the following further recommendations for the Commission to consider in its review:

- The availability of additional liquidity management tools should be consistent throughout all EU jurisdictions; a common EU legal framework governing the liquidity management tools would support this.
- The publication of IOSCO's recommendations for a framework assessing leverage in investment funds has led to a need to amend the current reporting of the gross method calculation in AIFMD level 2 to ensure alignment with the IOSCO framework.
- ESMA has called for further clarification of the proportionality principle for remuneration requirements, highlighting concerns previously expressed in a letter to the Commission in March 2016.
- Further legislative clarifications could be provided regarding the supervision of cross-border activities of UCITS and AIFs, their managers and delegates.
- ESMA believes there should be a specific framework for loan origination within the AIFMD.
- The AIFMD should be clarified to allow depositaries not to apply the delegation rules to central securities depositaries ("**CSDs**") in their capacity as Issuer CSDs.
- ESMA asks the Commission to consider the benefits of a depositary passport.
- The letter notes the different approaches to external valuer liability in different member states, with some states imposing liability in the event of "simple negligence" as well as "gross negligence", resulting in external valuers being unwilling to accept valuation mandates from AIFMs. ESMA's view is that "negligence" should be limited to "gross negligence" and this should be addressed directly in the legislation.
- ESMA suggests that there could be clearly definitions and rules regarding reverse solicitation, but accepts that this might also addressed under the evaluation clause in the regulation on cross-border distribution of collective investment undertakings.

## Comment

ESMA has been consistent in its push for greater clarity in relation to delegation, although its continued focus on this area may be unexpected as it had been widely thought that many of the concerns relating to delegation and substance addressed in its 2017 opinion had been satisfactorily addressed by industry and regulators. While ESMA is an important stakeholder in the review process, it is not clear whether the Commission will adopt some or all of the ESMA recommendations in its legislative proposal, expected in mid-2021. That Commission proposal will have to be considered by the Council of the EU and the European Parliament before a final text is agreed upon, which means that it is far from clear at present which aspects, if any, of the ESMA recommendations will ultimately be adopted in amending legislation. It is understood that the AIFMD review is not at the top of Commission's agenda at present and, allowing time for adoption by the EU law-making institutions and implementation, it is likely to be two years or more before any changes will be applied.

*Please get in touch with your usual Asset Management and Investment Funds Department contact or any of the contacts listed in this publication should you require further information in relation to the material referred to in this briefing note.*

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