THE
INVESTMENT
ASSOCIATION

Consultation on the AIFMD Review – Further Feedback

The Investment Association offers further feedback on some of the questions raised in its response to the European Commission's consultation on the AIFMD Review, in particular providing explanations for some of the responses given where there was no option in the survey to include these. This feedback should be read alongside the responses given in the survey.

I. Functioning of the AIFMD regulatory framework, scope and authorisation requirements

Question 4. Is the coverage of the AIFM licence appropriate?

We do consider the existing AIFM licence to be comprehensive, and do not believe further functions need to be added to the AIFM licence.

Question 6. Are securitisation vehicles effectively excluded from the scope of the AIFMD?

We are not aware of any significant issues arising with AIFMD in respect of securitisation vehicles, and in particular of any securitisation vehicles established by AIFMs that have inappropriately been classified as AIFs. The Securitisation Regulation appropriately addresses securitisation vehicles, and we do not see the need for any further measures to be introduced to the AIFMD in respect of securitisation vehicles.

Question 7. Is the AIFMD provision providing that it does not apply to employee participation schemes or employee savings schemes effective?

We are not aware of any difficulties that have arisen with employee participation schemes or employee savings schemes being inappropriately caught within the scope of the AIFMD.

Question 8. Should the AIFM capital requirements be made more risk- sensitive and proportionate to the risk-profile of the managed AIFs?

Such a proposal would introduce complexity into the calculation of capital requirements for AIFMs. Since AIFMs do not assume risks related to the AIFs they manager onto their balance sheets, it is not immediately apparent to us how risk-sensitive capital requirements would be calculated and calibrated, nor that such risk profiling of AIFMs would be appropriate. We are not aware that the present AIFM capital requirements have presented material issues from a prudential perspective, and do not see a benefit to introducing risk-sensitive provisions into these.

The combination of AUM linked capital and provisions for fixed overheads is in our opinion sufficient to cover regulatory capital risks for these types of activities. AIFMs not have run an own account trading or underwriting book or offer products which sit on their balance sheet which would require additional risk coverage. We believe that a combination of

AUM linked-capital and fixed overheads is sufficient to capture regulatory risks adequately. Alternative measures of assessing risk would be burdensome, especially for smaller AIFMs with the costs outweighing any likely benefits..

Question 9. Are the own funds requirements of the AIFMD appropriate given the existing initial capital limit of EUR 10 million although not less than one quarter of the preceding year's fixed overheads?

Given that AIFMs do not assume balance sheet risk in relation to their activities in managing AIFs, the existing AIFM capital requirements have proved sufficient to ensure AIFMs are appropriately capitalised for their activities. No data or facts have been presented to justify the need to make any changes to the existing capital requirements, including to the existing capital limits.

Question 11. Should the capital requirements for AIFMs authorised to carry out ancillary services under Article 6 of the AIFMD be calculated in a more risk-sensitive manner?

Given the limited scope of the ancillary services that can be performed by AIFMs, and that these services do not involve AIFMs assuming material balance sheet risks, we do not see that there is any requirement to introduce risk-sensitive capital requirements for those AIFMs authorised to carry out ancillary services.

In addition, we expect that these services should be assessed in accordance with the relevant IFD/R requirements for the relevant ancillary MiFID services. IFD/IFR has recently reviewed the appropriate level of risk-sensitivity for these activities and as such we do not believe further change is required.

II. Investor Protection

Question 38. Are there any additional disclosures that AIFMs could be obliged to make on an interim basis to the investors other than those required in the annual report?

As explained in our response to Question 37, we are of the view that the AIFMD and the broader EU regulatory framework already addresses the information needs of both professional and retail investors. Introducing additional disclosures will bring significant additional costs for limited benefit.

Question 39. Are the AIFMD rules on conflicts of interest appropriate and proportionate?

The current conflict of interest rules in the AIFMD are clear, and ensure that any conflicts of interests identified by the AIFM are appropriately managed in the interests of the AIF’s investors. These requirements are well understood by both the industry and the investors, and provide appropriate levels of protection for investors. There is always the possibility that a small number of bad actors will fail to manage conflicts of interests appropriately and fail to act in the interests of investors, but where such instances occur the conflicts of interest rules are robust enough for NCAs to take supervisory action in such cases, including imposing sanctions. The conflicts of interest rules do not require any amendment, indeed such amendments could undermine the protection of investors, but the rules do need to be consistently enforced by NCAs.

Question 40. Are the AIFMD rules on valuation appropriate?

The AIFMD rules on valuation provide a robust framework to ensure that AIF assets are fairly valued and that subscriptions and redemptions are at a price that fairly reflects the value of the assets. Crucially, these rules also provide some flexibility in how the valuation is determined, recognising that valuation practices will vary for different asset types, while ensuring in each case there is strong governance on this process.

The requirements introduced by AIFMD involved some changes to internal procedures at AIFMs, in particular the establishment of an independent valuation function within the AIFM, typically overseen by a valuation committee to provide oversight of the valuation of the AIF. With the industry having successfully adapted to the AIFMD valuation requirements, the IA does not believe there is any requirement to fundamentally change the AIFMD valuation rules..

Question 41. Should the AIFMD legal framework be improved further given the experience with asset valuation during the recent pandemic?

Overall, the governance of the valuation process proved robust during the recent pandemic. Importantly, when concerns arose on the accuracy of pricing sources in the markets, fair value processes were implemented when concerns arose around the accuracy of published price feeds, and ensured that other information sources were properly taken into account when determining valuations, ensuring that these as fairly as possible represented the circumstances in the market. Some funds chose to suspend dealing (such as UK property funds) due to material uncertainty in the valuation of their assets, ensuring investors were protected from any disadvantage due to subscriptions and redemptions being processed at inaccurate prices.

As such, the recent pandemic has highlighted the robustness of the existing valuation requirements, and we do not believe that any changes are needed.

Question 42. Are the AIFMD rules on valuation clear?

The AIFMD rules already provide sufficient clarity on the valuation requirements for AIFMs. Please also refer to our response to Question 40.1

III. International Relations

Question 49. Do you believe that national private placement regimes create an uneven playing field between EU and non-EU AIFMs?

NPPRs allow professional investors in a number of EU member states to invest alongside third country investors in investment opportunities which meet their investment requirements. In practice, it is rare for AIFs registered under NPPRs to be sold to exclusively EU investors.

Furthermore, while NPPRs could potentially allow third country AIFMs not subject to the same rules as EU AIFMs to market their AIFs to professional investors in a member state, and thus compete against EU AIFMs in that member state, in practice the ability for third country AIFMs to distribute their AIFs in the EU under the NPPRs is very restrictive. Some member states do not have NPPRs at all, excluding the possibility of third country AIFMs marketing their AIFs in those jurisdictions, and limiting their access to investors only through reverse-solicitation. Some member states have NPPR regimes that impose

additional requirements on third country AIFMs in respect of their AIFs being registered in under the member state's NPPR.

As such, this limited access for third country AIFMs entirely erodes any competitive advantage that they might otherwise have. Unless a third country AIFM is only intending to market in a small number of member states, for which they will have to comply with the conditions specified by those member states, they will typically establish an AIFM entity in the EU in order to offer AIFs to the EU market.

Question 50. Are the delegation rules sufficiently clear to prevent creation of letter-box entities in the EU?

Yes. The current rules provide national authorities with sufficient clarity to prevent the creation of letter-box entities in the EU, with no evidence of either market failure or increased risk to financial stability which would warrant changes to the current rules. Article 20 of the AIFM Directive requires that the Commission through delegated acts establishes strict conditions under which the AIFM shall be deemed to have delegated its functions to the extent that it becomes a letter-box entity and can no longer be considered to be the manager of the AIF, supplemented by Recital (8) which explicitly states that delegation arrangements should never amount to a de facto circumvention of this Directive by means of turning the AIFM into a letter-box entity, irrespective of whether the AIFM is established in the Union or in a third country.

When read in conjunction with Article 75 of the AIFMR, Article 82 provides national authorities with clear and coherent criteria to assess all delegation arrangements, including testing whether the AIFM no longer has the necessary expertise or resources to supervise the delegated tasks effectively, whether the AIFM no longer has the power to make key decisions under the responsibility of senior management, whether the AIFM loses contractual rights to inquire, inspect, have access, or give instruction to the delegate, and specific guidance on how to assess whether the delegation of functions can be objectively justified by the AIFM. This includes, among other matters, the types of assets the AIF invests in, and the type of investment strategy employed. The application of the criteria is the subject of detailed guidance to national authorities by ESMA in its 2017 Legal Opinion to ensure a convergent approach to the supervision of delegation. These requirements have been incorporated by national authorities through specific guidance (see, for example, the CBI's CP-86 or the CSSF's 18/698).

Introducing additional qualitative or quantitative criteria to that already included in the AIFMR would be not only disproportionate given the level of attention given to this topic both by ESMA and by national authorities, but would also be inconsistent with agreed best practice. As discussed in the 2018 ESA review, national authorities remain best placed to understand the complexities of the local market, with proximity an essential advantage in assessing whether delegation can be justified given an AIFMs structure and investment strategy in accordance with Article 82 of the AIFMR. Furthermore, the EU's Supervisory Convergence Network established in response to Brexit examined hundreds of "live" delegation cases to third countries submitted to it by local authorities. Importantly, no individual case of delegation was challenged, nor an AIFM denied the right to delegate, out of investor protection or financial stability concerns, suggesting additional clarification of these existing criteria is not required in relation to the use of letter-box entities.

Introducing limits on the maximum extent of delegated activity, or the ability to delegate specific would undermine the economies of scale carefully established by AIFM's

optimising their operations, and introduce new barriers to other providers from entering the market, in turn limiting competition and innovation in the EU's AIF market. Noting AIFs are typically marketed to institutional investors with sophisticated diversification and asset allocation strategies, the current flexibility in the regime allows local authorities to balance investor protection requirements with the need for AIFMs to be able to utilise global centres of expertise or access other specialist functions. Additional restrictions would impair the ability of AIMFs to fulfil their legal obligations to act in the best interests of its investors under Article 20 (e) of AIFMD, and raise costs for investors in EU AIFs, reducing the total available capital to be invested in the European post-pandemic recovery.

The ability to delegate is a critical enabler for the European investment management industry and is a key feature of the AIFMD. We share international concerns about the broader reputational impact restricting the ability to delegate specific functions may have on the EU AIF market over the longer-term. The AIFMD is widely regarded as a global financial services success story, and under effective supervision, continued international investment into AIFs will be crucial in the development of the CMU. Unjustified restrictions on the ability to delegate specific functions, in part inspired by political issues associated to Brexit, will weaken the attractiveness of the EU's AIF market for firms on an international basis, such as North America and Asia, and could risk similar measures being introduced by other major financial centres to the detriment of European savers and investors.

Question 51. Are the delegation rules under the AIFMD/AIFMR appropriate to ensure effective risk management?

The AIFMD provides a robust framework for risk management of all activities of AIFMs and the AIFs they manage, whether those activities are performed by the AIFM itself, or whether some activities are delegated. In our experience, it is unusual for risk management to be delegated, beyond the performance of some supporting tasks – AIFMs typically have an internal risk function that is independent of the portfolio fund management function (where this is proportionate to the size of the AIFM) that reports independently to the board, providing what is often referred to as “the second line” of defence for the AIFM. It is this requirement that satisfies the AIFMD requirement for an independent risk function at the level of the AIFM. This is over and above the risk management that is performed within the portfolio management function itself (often referred to as “the first line”), whether this activity is delegated or performed internally.

The existing delegation rules ensure that the responsibility for the delegated activity is retained by the regulated AIFM entity – there is no delegation of responsibility. In order to comply with the requirements, AIFMs must implement effective risk management and compliance structures and processes, retaining sufficient expertise within their AIFM entity to perform these functions. These are necessary for the AIFM to perform the necessary oversight on their delegates, whether performing investment or operational processes.

The existing framework for delegation ensures that European investors can benefit from access to global investment talent and international opportunities, and to efficient and effective operational processes, while ensuring there is a strong, independent and clearly delineated risk management function at the level of the AIFM to oversee these activities. We do not believe further measures are required in respect of risk management of delegated activities. Indeed, such measures may prove counterproductive to the effective management and operation of EU AIFMs and their AIFs.

IV. Financial Stability

Question 60. Should the AIFMD rules on remuneration be adjusted to provide for the de minimis thresholds?
We do not believe there is any need to adjust the remuneration rules applicable to AIFMs.

Question 73. Should any data fields be deleted from the AIFMR supervisory reporting template?
As noted in our response to Question 61.1, the existing reporting framework for AIFMD is already embedded, and the costs and resourcing of implementing system changes required as a result of changing the AIFMD reporting framework are likely to outweigh any benefits of removing data fields.

Question 74. Is the reporting frequency of the data required under Annex IV of the AIFMR appropriate?
AIFMs have developed the processes and systems necessary to deliver on the existing reporting frequency requirements. There is therefore no pressing need on the industry to change this.

Any increase in the frequency of data reporting would not only be very costly to deliver, but it is likely not to be operationally feasible in the case of many AIF types. This is likely to affect the accuracy of data reported to NCAs, with a need to make future adjustments and corrections, and would therefore limit the usefulness of the data reported.

Question 78. Should the formats and definitions be harmonised with other reporting regimes (e.g. for derivates and repos, that the AIF could report using a straightforward transformation of the data that they already have to report under EMIR or SFTR)?
The AIF industry does not see any case for revisiting the existing AIFMD reporting framework. As noted in our response to Question 61.1, AIFMD reporting is predominantly systems based, and firms have invested considerable resources in developing these systems and process, that are now embedded in their operations. Any implementation of changes to the AIFMD reporting framework will come with significant development costs for AIFMs and their corporate group, for very limited benefit for either AIFMs or NCAs.

We do agree that, in principle, any future regulatory reporting developed should be aligned where possible to existing reporting requirements, to minimise overlapping data requests and allow utilisation of existing systems development as much as possible. However, existing reporting requirements that have already been implemented, such as the AIFMD reporting framework, should not be amend solely for the purposes of harmonisation.

Question 84. Are the current AIFMD rules permitting NCAs to cap the use of leverage appropriate?
The current rules in Article 25 allow NCAs to cap the use of leverage. ESMA has now issued its guidelines for harmonising the use of this power by NCAs. It is unusual for the use of leverage in AIFs to present any significant risks to financial stability. Therefore, we would expect this to be used judiciously by NCAs only when strictly necessary for particular AIFs whose use of leverage significant risks to the wider financial system, and we would expect such circumstances to be rare.

VII. Miscellaneous

Question 97. Should NCAs be granted additional powers and competences beyond those already granted to them under the AIFMD?

We do not see any need for NCAs to be granted additional powers and competencies beyond those already granted to them under the AIFMD. The AIFMD already provided NCAs with comprehensive powers to intervene in the management of AIFs, such as requiring caps on leverage or for dealing in an AIF to be suspended, to take supervisory action and to issue sanctions where breaches of the AIFMD occur. Unlike other parts of financial services, we are not aware of any instances since the implementation of the AIFMD where NCAs wanted to take action against AIFMs but lacked the appropriate powers to do so.

These powers and competencies are only useful if properly and consistently applies, and in this respect, the recently issued report by ESMA on Sanctions taken by NCAs under the AIFMD is instructive. Firstly, we note that 2020 was the first year for which a report on sanctions taken by NCAs was published by ESMA, despite being under an obligation to do so. This report also advises that no supervisory actions were taken or sanctions issued in a third of EU member states, suggesting that there may be inconsistencies in how NCAs are using their existing powers. A more consistent application by NCAs of their existing powers and competencies under the AIFMD is needed, rather than additional powers and competencies.

Question 100. Should the sanctioning regime under the AIFMD be changed?

The current rules in Article 25 allow NCAs to cap the use of leverage. ESMA has now issued its guidelines for harmonising the use of this power by NCAs. It is unusual for the use of leverage in AIFs to present any significant risks to financial stability. Therefore, we would expect this to be used judiciously by NCAs only when strictly necessary for particular AIFs whose use of leverage significant risks to the wider financial system, and we would expect such circumstances to be rare.

Question 101. Should the UCITS and AIFM regulatory frameworks be merged into a single EU rulebook?

The IA does not agree with any proposed merger of the AIFMD and UCITS EU rulebooks, and believes this proposal raises significant risks to the operation and effectiveness of both frameworks. While both directives relate to investment funds, there are fundamental differences between the two directives – the AIFMD is a management company directive, covering the management of funds largely marketed to professional investors, whereas the UCITS Directive is a product directive for funds that are marketed to retail investors. Both the UCITS Directive and the AIFMD are working well – the UCITS Directive has become the global gold standard for retail fund regulation, and the AIFMD is increasingly recognised by professional investors. An extensive merger of these two rulebooks risks jeopardising this hard-won international reputation.

There is considerable risk that merging these rulebooks will result in inappropriate standards being applied to both regimes, eg investor protection standards that are not needed nor appropriate for professional investors, or financial stability measures that are not needed for strictly regulated retail products. Conversely, there is also the risk of an inappropriate dilution of standards for retail investors in an attempt to achieve a “one size fits all” solution.