European Commission Issues Report on the Impact of AIFMD

January 23, 2019

The Alternative Investment Fund Managers Directive (the "AIFMD"), which became fully operational in 2014, included provisions for its own review. The European Commission was required to begin a fairly thorough assessment in July 2017. As part of the preparation for that review (although later than planned), the Commission recently published a report (with associated press release) on the operation of the AIFMD (the "Report"). Whilst the Report, which was prepared by KPMG on behalf of the Commission, does not reflect the Commission's official views, it is a substantial document and will inevitably carry significant weight.

The Report focuses on the application of the in a number of EU Member States, including Denmark, France, Germany, Ireland, Luxembourg, the Netherlands and the United Kingdom. The major source of data for the Report was a survey of market participants regarding market developments following the AIFMD implementation. Approximately 85 percent of the 478 respondents to the survey were institutions, primarily fund managers or advisers. Industry associations, fund administrators, depositaries and institutional investors were amongst the other respondents. National competent authorities also provided data.

The findings of the survey of market participants are followed in the Report by an evidence-based study exploring the consequences of the AIFMD for investment funds in the EU market and the changes in the regulatory and supervisory framework for managers.

Overall, the Report is positive in its assessment of the AIFMD, finding that most provisions of the AIFMD have achieved their objectives, created uniform standards in the European Union and promoted investor confidence, although it notes that 84 percent of the 25 institutional investors (or bodies representing them) said that the AIFMD had *not* influenced their decision to invest in alternative investment funds. The Report identifies a relatively small number of areas with shortcomings or issues that need further work on harmonisation between member states. We highlight points of particular interest below.

Regulatory reporting. The Report points to problems of redundant, insufficient and duplicative data in the AIFMD's regulatory reporting obligation, as well as inconsistent requirements (regarding, for example, interpretation and formats for submission of data) amongst member states. However, the Report notes that, given the substantial investment so far by firms in systems to implement the reporting requirements, market participants might resist further changes to those requirements. Overall, the Report is positive on the benefits of regulatory reporting, concluding that regulatory reporting was useful for systemic risk monitoring by competent authorities and that there was no indication that the cost was unacceptable or disproportionate.

Leverage. The Report's survey found little use of high leverage by funds, with few concerns expressed by competent authorities on this issue. The Report finds that the AIFMD leverage provisions provide consistent and standardised rules for the calculation, reporting and risk mitigation of leverage within the European Union, giving competent authorities standardised data, although changes to these provisions are expected at a later stage of the AIFMD review in light of IOSCO's work on a common leverage measure. The Report did not comment on the uncertainties on measuring and reporting leverage in the private equity context.

Valuation. The Report notes generally that the quality of valuation is perceived to have risen and that in some asset classes, such as real estate, the AIFMD has led to AIFMs conducting valuation internally with support from external service providers, rather than relying entirely on external valuers as before. However, the Report identifies problems stemming from the differing interpretations amongst member states regarding the liability of external valuers.

Risk management. The Report notes a positive effect of the AIFMD on the governance, policies and procedures adopted by AIFMs for risk management. The Report finds that the requirement to fully separate risk and portfolio management has increased investor protection, while also recognising that meeting this requirement can be challenging for private equity and real estate managers.

Depositary. The Report points to differences in interpretation of depositary duties (such as cash monitoring duties) and to various practical problems with implementing the depositary rules, including delegation of custody to prime brokers, the appointment of U.S. prime brokers and the differing custody standards that prevent depositary groups from establishing a common EU model. The Report does not call for the application of the more stringent rules of the Undertakings for Collective Investment in Transferable Securities (the "UCITS") on asset segregation requirements to the AIFMD, which would prevent funds from investing in certain non-EU states or trading with certain counterparties.

Investor disclosures. The Report notes a "strength of opinion" amongst respondents that the investor disclosure requirements in the AIFMD are excessive and not helpful to investors, at the same time noting that some institutional investors say they are still not receiving standardised disclosures relating to, for instance, private equity fees and costs. The Report also calls for the AIFMD review to consider the consistency of the AIFMD disclosure requirements with other EU disclosure regimes.

Private equity investment in non-listed companies. The Report makes various criticisms of these rules, pointing to their "marginal measurable impact." In particular, the notifications to competent authorities required under the AIFMD following acquisition of control of EU companies are not viewed as useful or essential, as it is not clear what competent authorities can or do make of the information. Further work is also needed in conforming the interpretation of terms such as "non-listed company" and the treatment of holding companies. Respondents also do not regard the AIFMD as improving the quality of information provided by AIFMs to acquired companies. The survey also noted different interpretations - even within member states - of the asset stripping rules.

Single-market passport. The Report is generally positive in its assessment of the AIFMD marketing passport, noting a steep increase in marketing of EU funds on a cross-border basis within the European Union. The Commission has previously highlighted specific problems with the EU marketing passport, such as the different interpretation of the "pre-marketing" concept and local fees. The Report notes that many respondents want national private placement regimes to be retained after the introduction of the third-country passport regime. However, there has been little progress in this area, with marked differences within member states in the demand by professional investors for non-EU funds. The Report does not address the fragmented market for smaller private equity AIFMs, who either have to step in to full compliance or face a patchwork of national rules that often provide less market access than for equivalent third-country firms. National private placement regimes are described as being of "added value" in light of limited progress regarding the third-country passport regime.

Although the Report includes a host of interesting comparative data, it does not provide definitive recommendations and is therefore of limited use in anticipating what changes the Commission may propose to the AIFMD when it completes its review, expected to be in 2020. The Commission will likely also look at areas not fully considered by KPMG, such as alignment of the AIFMD to relevant parts of the new version of the Market in Financial Instruments Directive introduced in 2018, and (as mandated by the AIFMD) whether to enhance the supervisory responsibility of the pan-EU securities regulator, ESMA.

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