

AIFMD Review: ESMA Publishes Its Recommendations for Improvements

25 August 2020

As an important step in the review of the EU Alternative Investment Fund Managers Directive (“AIFMD”), the European Securities and Markets Authority (“ESMA”) has [published](#) a letter to the European Commission (the “Commission”) outlining areas of AIFMD for possible change. The Commission will publish a proposal for the AIFMD review, expected later this year, and ESMA’s views are likely to carry significant weight.

We cover in this update some key aspects of ESMA’s proposals, with a particular focus on the impact on private equity and private debt funds.

Clarification for AIFMs performing additional MiFID services. ESMA points to the need for clarification on the position of alternative investment fund managers (“AIFMs”) which also perform services (such as segregated portfolio management) under a “top-up” authorisation under the Markets in Financial Instruments Directive (“MiFID”). For instance, ESMA highlights that MiFID II rules on transaction reporting do not currently apply to AIFMs. The AIFMD review may well lead to the imposition of MiFID II rules on the MiFID services performed by an AIFM, and it is possible that any such changes will also be carried across to the AIFM’s core business.

Delegation of portfolio management. ESMA notes the heavy reliance by AIFMs on delegation arrangements (including those funds that pay a “large amount of the management fees generated by the AIFM to the delegate”) and suggests clarification on the “maximum extent” of such arrangements and the substance required for EU AIFMs. It is not surprising that ESMA continues to focus work in this area, particularly in light of Brexit, and it has already published its views on the delegation in its 2017 opinions, including identifying those “critical functions” that, in its view, an AIFM cannot delegate. It is possible that the AIFMD review will propose some legislative basis for ESMA’s opinions on the scope and scale of delegation allowed. For AIFMs that currently rely on delegation to firms outside the EU, this is an important area to watch.

Use of seconded staff. ESMA notes the popularity of secondment arrangements, where staff from group entities or professional services firms are seconded to an AIFM on a temporary basis. ESMA notes that these frequently take place on a cross-border basis,

with the consequence that staff seconded to an AIFM are in practice operating elsewhere in the EU, or outside the EU. ESMA points to the possibility of legislative work to address the concern that these arrangements are in line with the substance and delegation rules set out in the AIFMD. This is another important area to watch, in particular in relation to secondment arrangements for staff engaged in marketing activities, who are in practice often based outside the AIFM's jurisdiction.

Supporting tasks performed by AIFM. ESMA notes that group entities often provide “supporting tasks” to the authorised AIFM (such as compliance or IT support), with different approaches as to whether such arrangements count as delegation of an AIFM's functions and are thereby subject to the control and supervision framework for delegation in the AIFM. This is in line with ESMA's interpretation of the scope of the delegation requirements under AIFMD (which, in its view, apply to the both the “key” functions of portfolio and risk management and the “ancillary” functions of, for instance, fund administration and legal support) and may result in changes to AIFMD to confirm ESMA's interpretation.

Host AIFMs. ESMA terms third-party AIFMs that act in a “host” capacity “white label service providers” and calls for specific rules to address their role. ESMA's specific concern here is that there could be a conflict of interest for the host AIFM, given its obligation to manage the fund in the interests of investors and the influence that the fund's sponsor, its client, can bring to bear on the host AIFM. Although there are arguments that the AIFMD already addresses this (not least, the host AIFM's own regulatory liability for breach of regulatory standards), ESMA may persuade the Commission to address the position of third-party AIFMs. It is not clear, however, how ESMA's concerns would translate into concrete legislation.

Leverage. ESMA supports recent work by IOSCO on a more refined method for assessing fund leverage. IOSCO's two-step approach involves regulators first determining which funds pose a financial stability risk (broadly on the basis of “gross notional exposure”) and, as a second step, defining specific ways of assessing leverage for riskier funds. We can expect to see changes to the AIFMD in this regard.

Semi-professional investors. A number of EU states allow marketing of AIFs to various classes of “semi-professional” investor (such as high net worth individuals), with definitions varying amongst states. Unfortunately, ESMA does not clearly signal its support for introducing this category on a consistent basis across the EU under AIFMD, noting that, if it is introduced, it “should be accompanied by appropriate investor protection rules and passporting activities should be allowed only in relation to the marketing to professional investors.” This may conflict with the approach of some member states to extend the marketing passport to national semi-professional investors.

Loan origination. ESMA has not given views on the subject of loan origination by funds (non-bank lending) since it published an opinion in 2016, where it called for an EU-wide regime for authorisation of loan originating funds with specific rules governing the management of risks relating to loan origination. It also suggested that loan-originating funds should only be “closed-ended” vehicles, without investor redemption rights. In its letter to the Commission, ESMA refers to its 2016 opinion and reiterates its view for a specific framework for loan origination, noting at the same time that the EU is already carrying out work to support loan origination in the European Long Term Investment Fund (“ELTIF”) framework. It is unclear how an AIFM loan origination framework will fit with the ELTIF changes. Some member states (such as Germany and Luxembourg) have already imposed a specific risk management framework on AIFMs in their jurisdiction that manage loan originating funds, with Germany currently restricting loan origination to German closed-ended funds with professional and semi-professional investors only. In Luxembourg, the regulator scrutinises each AIFM intending to manage loan originating funds against set criteria (such as the necessary expertise and appropriate technical and human resources) before permitting the AIFM to manage funds of this type.

External valuers. In a potentially helpful change, ESMA suggests amending the liability standard for external valuers in the AIFMD to a “gross negligence” standard. AIFMD currently requires the external valuer to be liable to the Fund for losses that arise from its “negligence”, generally discouraging the appointment of external valuers.

Reverse solicitation. The concept of “reverse solicitation” (marketing a fund other than at the initiative of the AIFM) is subject to different interpretations throughout the EU. ESMA argues that it is important to clarify the notion of reverse solicitation in the new version of AIFMD. It is unknown whether any attempt at legislative clarity will benefit the industry or create new obstacles to reverse solicitation, which is already heavily restricted.

ESMA includes a separate annex of suggestions for improvements across a range of reporting requirements (in particular in relation to “Annex IV” regulatory reporting). Points of note for private equity are a suggestion for funds to report their ESG metrics and for private equity funds to report limited recourse leverage at the level of the holding company structure in which they invest. The suggestion that private equity funds report leverage at the level of the holding company structure may result in removal of the current exemption for private equity funds to disregard such leverage, with potentially very significant impacts for such funds.

The letter is an interesting round-up of topics on ESMA’s agenda. Many of the topics that ESMA raises reflect items that have been on its agenda for a number of years, in particular those relating to substance and delegation, and some technical matters on

which it has published interpretations—although in some cases, Brexit has amplified the concerns that are being expressed. A number of other topics are new themes, or issues - such as loan origination - which the industry may have considered not current areas of focus for ESMA. Although the Commission will have the final say on the proposals, ESMA's views will inevitably influence the Commission's proposed agenda.

Post Brexit, the UK is not bound to implement any changes to AIFMD, and it is unknown whether the UK government (with the assistance of the FCA) will propose changes, although the UK government may take into account particular clarifications and improvements adopted by the EU of benefit to UK managers.

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