



September 2020

ESMA's letter to the European Commission on its review of AIFMD

Background

On 18 August 2020, ESMA issued a [letter](#) to the European Commission (the "Commission") highlighting nineteen (19) areas where, in ESMA's opinion, improvements could to be made to the regulatory framework currently in place for alternative investment funds ("AIFs") and which ESMA believes the Commission should consider as part of the Commission's scheduled review of the Alternative Investment Fund Managers Directive ("AIFMD") (the "Letter")¹. The Letter was issued to assist the Commission in its review of AIFMD with its recommendations based on ESMA's experiences with national competent authorities ("NCAs") on the operation of AIFMD since it was first published in 2011.

It is worth noting at the outset that while the Letter was issued in light of the impending review by the Commission of AIFMD, ESMA's recommendations may, if implemented, have significant implications not only for the AIFMD framework but also the UCITS framework.

In this briefing, we consider a number of the key points raised by ESMA in the Letter.

Delegation and substance

Delegation

ESMA has once again highlighted concern with the existing legislative provisions governing delegation and substance and has recommended that both the AIFMD and UCITS legislative frameworks are revised in line with its [Opinion](#) which it issued in July 2017 following the United Kingdom's decision to withdraw from the

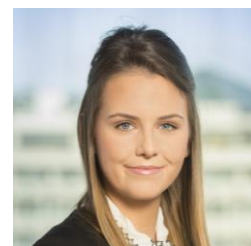
For further information on any of the issues discussed in this article please contact:



Cillian Bredin
+ 353 1 673 1889
cillian.bredin@dilloneustace.ie



Shane Coveney
+ 353 1 673 1749
Shane.Coveney@dilloneustace.ie



Hannah Fenlon
+ 353 1 674 1005
Hannah.Fenlon@dilloneustace.ie

¹ Pursuant to Article 69 of AIFMD, the European Commission is required to review the application of AIFMD. In June 2020, the Commission issued its [report](#) to the European Parliament and the European Council assessing the application of AIFMD.

European Union.

Noting the current practice of AIFMS and UCITS management companies delegating collective portfolio management functions to third parties and the likely increase of such delegation arrangements to non-EU entities in light of Brexit, ESMA highlights the operational and supervisory risks associated with such delegation arrangements. It suggests that the legislative frameworks be updated to provide further clarification on the maximum extent of delegation to ensure that sufficient substance remains in the EU. In this regard, it proposes that existing legislative provisions in AIFMD be revised to include quantitative criteria which must be complied with when delegating functions to a third party or a list of “core” or “critical” functions which cannot be delegated to third parties and must be performed internally².

In order to address regulatory arbitrage and possible circumvention of AIFMD/UCITS regulatory standards which may arise in delegation arrangements by virtue of the fact that the delegate is not directly subject to the AIFMD or UCITS frameworks, ESMA also recommends that legislative amendments be adopted to ensure that the management of AIFs and UCITS is subject to the regulatory standards set out in the AIFMD and UCITS framework, irrespective of the regulatory license or location of the delegate.

Third Party Management Companies

ESMA’s letter also raises concerns regarding “white-label service providers” (typically referred to in Ireland as “third party management companies”) which is a model used in certain EU jurisdictions such as Ireland and Luxembourg under which a promoter which wants to establish a fund in the relevant jurisdiction and which does not have a related UCITS management company or AIFM to provide relevant management services to the fund approaches a “third party management company” to provide UCITS management company/AIFM services to the relevant fund. The promoter is then appointed by the UCITS management company/AIFM as a delegate investment manager of the fund. In ESMA’s view, such arrangements can create conflicts of interest as a result of the fact that the promoter has the ability to replace the management company, which, in turn, could in practice hamper the ability of the management company to comply with its regulatory obligations to act in the best interest of the fund by challenging the delegate investment manager given the risk that it could then lose the fund client.

ESMA advises that in the event that the Commission determines that such arrangements are permissible, specific regulatory provisions to address conflicts of interests and investor protection risks should be incorporated into both the UCITS and AIFMD frameworks.

Secondment Arrangements

In addition to the above, ESMA notes the growing prevalence of secondment arrangements in the market where staff are temporarily seconded to regulated AIFMs and UCITS management companies to perform certain functions –often in cases where the seconded individuals are not actually operating in the Member State of establishment of the AIFM/UCITS management company but instead continue to work from their usual offices outside of the EU. ESMA suggests that this raises questions in relation to the compliance with substance requirements and, more particularly,

² In particular, ESMA cites Article 82 of Commission Delegated Regulation (EU) 231/2013 which sets out the circumstances in which an AIFM will be deemed to be a “letter-box entity”

with the applicable delegation rules under AIFMD and UCITS and suggests that further legislative clarifications in this area may be beneficial to regulators in seeking to address any such issues.

Distinction between “collective portfolio management functions” and “supporting tasks”

As readers will be aware, AIFMD makes clear that the rules on delegation should apply to the delegation of management functions set out in Annex I thereto while delegation of “supporting tasks” should not be subject to such rules³.

ESMA notes in its Letter that NCAs have in certain cases divergent opinions as to what constitutes a “supporting task” when determining whether or not the delegation rules must be observed by the third party performing the relevant task. As a result, it suggests that the legislative frameworks be revised to include more “specific and granular” requirements to provide greater legal certainty on which type of task will fall within the scope of the delegation rules and which type of task will constitute a “supporting task”.

It is also worth noting that ESMA has called on the Commission to codify the [Q&A](#) it published on the topic of delegation in which it advised that an AIFM is responsible for ensuring compliance with the delegation rules in respect of all functions set down in points 1 and 2 of Annex 1 of AIFMD, which includes not only investment management functions but also administration and marketing functions even where such third parties have been appointed directly by the relevant AIF rather than the AIFM to perform such functions.

External valuer liability

An external valuer is considered under AIFMD to be a delegate of the relevant AIFM and the AIFM’s liability to the AIF is not affected by the appointment of an external valuer. In this regard, Article 19(10) of AIFMD states that where an external valuer is appointed, “*the external valuer shall be liable to the AIFM for any losses suffered by the AIFM as a result of the external valuer’s negligence or intentional failure to perform its tasks*”.

In its Letter to the Commission, ESMA notes that some external valuers in certain jurisdictions are not willing to provide valuation services to AIFMs on the basis that they are not willing to be liable to the AIFM for losses suffered by their “simple” negligence. ESMA has therefore called on the Commission to revise Article 19(10) of AIFMD to reference a standard of “gross negligence” instead of “negligence” which would result in an AIFM having to prove that the external valuer was grossly negligent in order to recover for losses suffered by it as a result of the external valuer’s actions.⁴

Amendments to leverage calculations

Under current rules, AIFMS must calculate (and report) leverage by two different measurements – the gross or ‘notional’ exposure and the commitment method⁵.

ESMA has suggested that the “gross” method for calculating leverage should be revised in light of the [IOSCO Recommendations for a Framework assessing Leverage in Investment Funds](#) which

³ Recital 31 of AIFMD

⁴ From an Irish perspective, the concept of “gross negligence” has only recently been considered by the Irish courts in the case of *ICDL GCC Foundation FZ-LLC & anor v European Computer Driving Licence Foundation Ltd* [2012] IESC 55

⁵ Article 7 of Commission Delegated Regulation (EU) No 231/2013

was issued in December 2019 in order to ensure consistency between the two frameworks. ESMA indicates that by making such an amendment, the Commission would provide regulators with a means of efficiently identifying those funds that are more likely to pose risks to the financial system.

Clarification of the proportionality principle for remuneration requirements

ESMA has called upon the Commission to revise both the UCITS and AIFMD frameworks to clarify that the proportionality principle applies to all of the remuneration rules in order to ensure that the quantitative variable remuneration thresholds and pay-out structures are only applied where it is proportionate to do so taking into account the size, internal organisation and nature, scope and complexity of the activities of the relevant UCITS management company/AIFM. ESMA had previously highlighted its concerns in this regard in its [letter](#) to the European Commission in March 2016. The Letter seeks to bring this matter back to the fore of the Commission's review of AIFMD.

Harmonised AIFMD and UCITS regimes

ESMA notes that in respect of certain matters (such as risk management and liquidity management) the requirements prescribed under AIFMD are more granular than the corresponding UCITS requirements. ESMA indicates that such inconsistency in the specific area of liquidity management is not ideal given that UCITS may also face liquidity issues despite being invested in transferrable securities and money market instruments. It also notes that there are no granular "Level 2" measures on delegation in the UCITS framework while such provisions have been set down in the AIFMD framework.

As a result, ESMA calls on the Commission to align the two frameworks where appropriate which it believes would be beneficial to both NCAs and market participants alike.

Harmonised reporting for UCITS

Continuing the theme of harmonisation between the UCITS and AIFMD regime, ESMA suggests that once improvements to AIFMD Annex IV reporting have been made, harmonised UCITS reporting should generally be aligned with those requirements (while allowing for tailoring to the characteristics of UCITS funds) in order to allow for sufficient monitoring of potential vulnerabilities which could contribute to systemic risk. This follows an [ESRB Recommendation](#) in 2017 which called for a harmonised reporting regime to be put in place for UCITS management companies.

Scope of additional "MiFID" services and application of rules

ESMA also addresses the scope of permissible business activities listed in Article 6(4) of AIFMD and Article 6(3) of the UCITS Directive in conjunction with Annex I of AIFMD and Annex II of the UCITS Directive, often referred to as "MiFID top-up services". As a result of divergent views amongst NCAs on the ability to undertake business activities other than those explicitly listed in the relevant legislative provisions, permissible business activities of management companies are broader in some Member States than others.

It has also called on the Commission to revise the legislation to eliminate any legal uncertainty around the precise application of rules in certain specific cases, citing by way of example whether or not the AIFMD/UCITS/MiFID rules should apply in respect of discretionary portfolio management or investment advices on assets that do not qualify as "financial instruments" under section C of Annex

I of AIFMD such as real estate, taking into account that the relevant MiFID provisions do not apply to them.

ESMA also sees merit in clarifying the UCITS, AIFMD and MiFID frameworks to ensure that the same regulatory standards are applied to all three types of entity when providing the same type of services such as marketing.

Availability of additional liquidity management tools

ESMA believes that the availability of additional liquidity management tools (“LMTs”) should be consistent throughout all EU jurisdictions. ESMA’s view is that the Commission should take the opportunity of the AIFMD review to include the availability of all LMTs as outlined in the ESRB Recommendation and also calls for LMT to be included in the UCITS Directive.

Other areas considered by ESMA in the Letter

There are a number of other areas considered by ESMA in Annex I of the Letter which include the following and can be considered further by readers:

- ▣ Clarification on reverse solicitation;
- ▣ Application of additional requirements for sub-threshold AIFMs;
- ▣ Harmonisation of supervision of cross-border entities;
- ▣ Inclusion of a definition of semi-professional investors;
- ▣ Establishment of a specific framework for loan origination in AIFMD;
- ▣ Application of depositary rules to central securities depositaries;
- ▣ Amendments to definitions in AIFMD such as defining “AIFs”;
- ▣ Convergence in treatment of the concept of ‘significant influence’;
- ▣ Increasing digitalisation in AIFMD;
- ▣ Further consideration of the utilisation of the depositary passport; and
- ▣ Key reporting issues where improvements could be made

Review by the Commission

ESMA’s Letter will feed into the broader review being undertaken by the Commission in relation to the application of AIFMD.

It is anticipated that the Commission will issue a detailed consultation paper outlining certain matters which are under specific consideration shortly. Following the conclusion of the consultation process, the Commission will review the contents of the Letter together with any other responses to its consultation paper with a view to issuing draft amending legislation which we anticipate to occur next year.

Should you have any queries in respect of the issues raised in this article, please do not hesitate to contact any member of the Asset Management and Investment Funds Department.

Dillon Eustace
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DILLON  EUSTACE

Dublin

33 Sir John Rogerson's Quay, Dublin 2, Ireland. Tel: +353 1 667 0022 Fax: +353 1 667 0042.

Cayman Islands

Landmark Square, West Bay Road, PO Box 775, Grand Cayman KY1-9006, Cayman Islands. Tel: +1 345 949 0022 Fax: +1 345 945 0042.

New York

Tower 49, 12 East 49th Street, New York, NY10017, U.S.A. Tel: +1 212 792 4166 Fax: +1 212 792 4167.

Tokyo

12th Floor, Yurakucho Itocia Building, 2-7-1 Yurakucho, Chiyoda-ku, Tokyo 100-0006, Japan. Tel: +813 6860 4885 Fax: +813 6860 4501.

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