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**COMMISSION STAFF WORKING DOCUMENT**

**Assessing the application and the scope of Directive 2011/61/EU of the European Parliament and of the Council on Alternative Investment Fund Managers**

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## **ABBREVIATIONS**

AIF	Alternative Investment Fund
AIFM	Alternative Investment Fund Manager
AIFMD	Directive on Alternative Investment Fund Managers 2011/61/EU
AIFMR	Commission Delegated Regulation (EU) No 231/2013
AIMA	Alternative Investment Management Association
AMIC	Asset Management and Investors Council of ICMA
AML	Anti-money laundering
AuM	Assets under management
CLO	Collateralised loan obligation
CMU	Capital Markets Union
CIU	Collective Investment Undertaking
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation
CSD	Central Securities Depository
CSDR	Central Securities Depositories Regulation
DG FISMA	Directorate-General for Financial Stability, Financial Services and Capital Markets Union
ECB	European Central Bank
EGESC	Expert Group of the European Securities Committee
ELTIF	European Long-Term Investment Fund
EEA	European Economic Area
EFTA	European Free Trade Association
EFAMA	European Fund and Asset Management Association
ELTIF	European Long-Term Investment Fund
EMIR	European Market Infrastructure Regulation
ESAs	European Supervisory Authorities
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
EU	European Union
EuVECA	European Venture Capital Fund
FSB	Financial Stability Board

FoF	Fund of Funds
HF	Hedge funds
ICMA	International Capital Market Association
IMSC	ESMA Investment Management Standing Committee
IOSCO	International Organization of Securities Commissions
KID	Key information document (PRIIP)
KIID	Key investor information document (UCITS)
MiFID	Markets in Financial Instruments Directive
MMFR	Regulation on Money Market Funds
MoU	Memorandum of Understanding
NAV	Net asset value
NCA	National Competent Authority
NPPR	National private placement regime
PE	Private equity
PRIIP	Packaged Retail and Insurance-based Investment Products
RAIF	Reserved Alternative Investment Fund (Luxembourg)
RE	Real estate
SFTR	Securities Financing Transactions Regulation
SWD	Commission staff working document
UCITS	Undertakings for the Collective Investment in Transferable Securities
UCITSD	UCITS Directive

# 1. INTRODUCTION

## 1.1 Background

The Alternative Investment Fund Managers Directive<sup>1</sup> (AIFMD) was adopted following the global financial crisis to improve supervisory oversight of the alternative asset management sector. Whilst seeking to ensure a coherent supervisory approach to the risks of the financial system and to provide a high level protection to investors, the Union co-legislators also sought to facilitate integration of the AIF market, which was suffering from regulatory fragmentation and thus from hampered development.<sup>2</sup>

The AIFs' universe is heterogeneous in terms of investment strategies, markets, asset types and legal forms. The diverse investment strategies pursued by different types of AIF expose those AIFs and their investors to a wide range of potential risks and may result in specific vulnerabilities in the financial system. The EU co-legislators considered that regulation of the EU alternative investment fund sector could be best achieved by focusing on establishing common requirements for the AIFMs as opposed to their managed AIFs.<sup>3</sup> As a result, the AIFMD governs the authorisation and operation of AIFMs managing all types of AIFs, irrespective of their legal structure or the investment strategy employed, in so far as the managed investment funds are not covered by the Directive 2009/65/EC (UCITSD).<sup>4</sup>

The review clause of the AIFMD requires the European Commission to carry out an assessment and to provide the European Parliament and the Council with a report on the application and the scope of the AIFMD. The purpose of this Commission Staff Working Document (SWD) is to complement the report adopted by the European Commission and to explain in further detail the assessment of the AIFMD rules.

## 1.3 Methodology and consultation process

To prepare this SWD and the report to the Union's co-legislators, the European Commission has tasked an external contractor – KPMG<sup>5</sup> – to conduct a General Survey and evidence-based study providing a comprehensive assessment of the AIFMD.<sup>6</sup>

The KPMG findings are complemented by other sources of information, including relevant data updates and information yielded through various work streams of Directorate General for Financial Stability, Financial Services and Capital Markets Union (FISMA),<sup>7</sup> European

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<sup>1</sup> Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010, OJ L 174, 1.7.2011, p. 1 (AIFMD).

<sup>2</sup> Recitals 2 - 4 and 94 of the AIFMD; Commission of the European Communities Green paper on the enhancement of the EU framework for investment funds, 12.7.2005, COM/2005/0314 final, p. 9.

<sup>3</sup> This shift of paradigm has even prompted some EU Member States to no longer require a separate authorisation for certain types of AIFs, for example, Luxembourg RAIFs.

<sup>4</sup> Article 4(1)(a) of the AIFMD.

<sup>5</sup> KPMG Law Rechtsanwalts-gesellschaft mbH as lead firm, with the subcontractors KPMG AG Wirtschaftsprüfungsgesellschaft, Germany and KPMG LLP, United Kingdom supported by the European network of KPMG.

<sup>6</sup> The General Survey took the form of an online questionnaire, which was running between 6 February 2018 and 29 March 2018. When carrying out the survey, KPMG was guided by a list of aspects laid down in Article 69(1) of the AIFMD on which stakeholders were invited to share their experiences.

<sup>7</sup> Responses to the Commission's Call for Evidence on the EU Regulatory Framework for Financial Services, responses to the Commission's Consultation on Cross-Border Distribution of Funds (UCITS, AIF, ELTIF, EuVECA and EuSEF) across the EU.

Securities and Markets Authority (ESMA)<sup>8</sup> and the European Systemic Risk Board (ESRB).<sup>9</sup> The Commission’s interaction with stakeholders, comprising national competent authorities (NCAs), industry representatives and investor protection associations, through public consultations, bilateral and multilateral meetings also contributed to the process. Specific examples of the application of the Union rules were taken into account. Academic and statistical publications further informed this report. For example, ESMA’s Annual Statistical Reports on EU AIFs was particularly useful in describing the EU AIF market.<sup>10</sup>

On 27 September 2019 the Commission consulted the Expert Group of the European Securities Committee (EGESC) representing the Member States to receive technical and policy feedback on the application and the scope of the AIFMD, including suggestions for improving the legal framework. The European Parliament, the Council, ESMA, the European Central Bank (ECB) are observer members of the EGESC and were invited to participate. EGESC members, i.e. the EU Member States, were also invited to make written submissions, which were taken into account.

On 22 of October 2019 the Commission presented the key elements of this report to the ESMA Investment Management Standing Committee (IMSC) and sought its input drawing on the supervisory experience of NCAs.

## **2. ASSESMENT OF THE APPLICATION AND THE SCOPE OF THE AIFMD**

### **2.1 AIFMD impact on AIFs**

An “alternative investment fund” is defined by the AIFMD as all collective investment undertakings (CIU) excluding funds authorised under the UCITSD.<sup>11</sup> AIFs can invest in a wide range of assets and use leverage. AIFs comprise a broad range of types, including hedge funds, fund of funds, private equity funds, real estate funds and other types of funds depending on the structure and the asset class. The following sections discuss the AIFMD’s effect on the EU AIF market.

#### **2.1.1 Single Market for EU AIFs**

##### *a) AIF market*

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<sup>8</sup> Opinion of ESMA on the functioning of the AIFMD passport and expected opinion on asset segregation, figures received by ESMA from NCAs on the use of National Private Placement Regimes, 30 July 2015, ESMA/2015/1235; ESMA thematic study among National Competent Authorities on notification frameworks and home-host responsibilities under UCITS and AIFMD, 7 April 2017, ESMA 34-43-340.

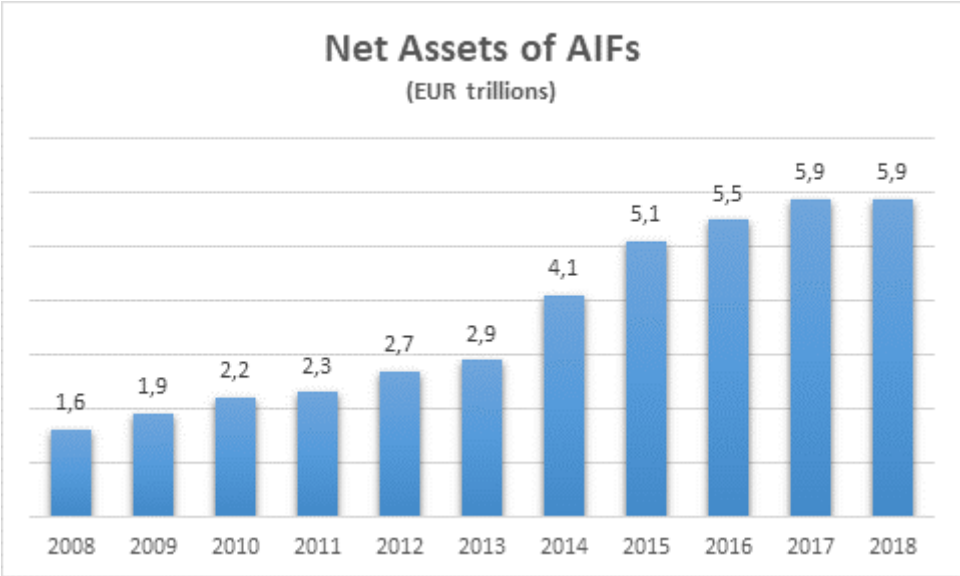
<sup>9</sup> Recommendation of the European Systemic Risk Board of 7 December 2017 on liquidity and leverage risks in investment funds ESRB/2017/6, 2018/C 151/01.

<sup>10</sup> ESMA Annual Statistical Report EU Alternative Investment Funds 2019, 21.01.2019, ESMA 50-165-748. (ESMA Statistical Report 2019) and ESMA Annual Statistical Report EU Alternative Investment Funds 2020, 10.01.2020, ESMA50-165-1032, (ESMA Statistical Report 2020).

<sup>11</sup> Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities, OJ L 302, 17.11.2009, pp. 32 - 96.

According to the available data, the EU asset management industry has grown significantly since the adoption of the AIFMD (*see* Table 1).<sup>12</sup> At the end of 2018 the net assets<sup>13</sup> of EU investment funds (UCITS and AIFs) reached a total of € 15.2 trillion, of which 39% or € 5.9 trillion is invested in 28,600 AIFs<sup>14</sup> as compared to 27% or € 2.3 trillion in 2011<sup>15</sup> and to 27% or € 1.6 trillion in 2008.<sup>16</sup> AIF assets have recorded continuous growth rates virtually every year since 2008 more than doubling in the period between the adoption of the AIFMD and now.

**Table 1. AIFs Net Assets**



*Source: EFAMA Fact Book 2019, page 27.*

The EU AIF industry is concentrated in a few countries – Germany, France, the Netherlands Luxembourg and Ireland – accounting for more than 82% of the net assets of the industry.<sup>17</sup> At the end of 2018 the share of net assets of AIF market of Germany stood at 29%, 18% was the share attributable to France, whereas the shares of Netherlands, Luxembourg and Ireland were 13%, 12% and 10% respectively.<sup>18</sup> In 2018 the strongest growth rates in AIFs net assets were registered in Cyprus (48%), Czech Republic (32%), Greece (14%) and Malta (11%).<sup>19</sup>

<sup>12</sup> The first ESMA Annual Statistical Report on EU Alternative Investment Funds of 2019 covers 80% of the market and is complemented by industry data provided in the EFAMA Fact Book 2019, fund data retrieved from the Morning Star and ECB statistics.

<sup>13</sup> Total of € invested in all share classes of AIFs.

<sup>14</sup> According to EFAMA Fact Book 2019, pp. 10 and 31; ESMA figures laid down in the ESMA Statistical Report suggest € 5.86 trillion AuM in AIFs as of end 2018 and ~30,350 AIF funds (absolute number), see ESMA Annual Statistical Report 2020, p. 7.

<sup>15</sup> See EFAMA Fact Book 2019, pp. 10 and 31: for the years 2008-2013, total funds do not equal the sum of UCITS and AIF due to the fact that the Netherlands was unable to provide a breakdown between UCITS and AIFs.

<sup>16</sup> UCITS assets accounted 61% of the total investment fund market in 2018 compared to 73% in 2008. EFAMA Fact book 2019, pp. 10 and 15.

<sup>17</sup> See EFAMA Fact Book 2019, p. 42.

<sup>18</sup> Ibid.

<sup>19</sup> Ibid.

The EU AIF market is very diverse in terms of types of funds, strategies and risk profiles of AIFs. The ESMA Statistical Report 2020 shows that limitations in categorising AIFs, dictated by the reporting template contained in the AIFMR, allow for only a crude breakdown of the EU AIF market.<sup>20</sup> Notably, besides funds of funds, real estate funds, hedge funds and private equity funds there were 15,180 “other types” of funds, which have predominantly fixed income or equity strategies or a strategy that does not explicitly fall within the established categories.<sup>21</sup>

In terms of geographical focus, EU AIFs invest mainly in the EEA (63%), followed by North America (16%) and supranational issuers (9%).<sup>22</sup>

**Table 2: EU Alternative Investment Funds: essential statistics and market structure in 2018**<sup>23</sup>

	Funds of Funds	Real Estate	Hedge Funds	Private Equity	Other AIFs	All AIFs
<b>Size</b>						
Number of funds (Absolute number)	5,430	3,442	1,449	4,369	15,180	30,357
Number of leveraged funds (Absolute number)	325	1112	568	91	2495	4591
Net Asset Value (EUR bn)	841	730	333	352	3553	5859
Average fund size (EUR mn per fund)	150	210	230	80	230	190
Share of total market (NAV % of all AIFs)	14%	12%	6%	6%	62%	100%
<b>Distribution</b>						
EU passport (% of total)	76%	75%	30%	60%	80%	76%
Retail participation (% of total)	30%	21%	2%	5%	164	16%
<b>Exposures</b>						
Main exposures (Asset type)	CIU	PA	IRD	S	S	IRD
Main exposures (% of exposures)	72%	68%	81%	79%	59%	57%
<b>Leverage</b>						
Gross leverage (% of NAV)	118%	132%	5,514%	113%	162%	442%
Adjusted leverage (% of NAV)	118%	130%	1052%	113%	148%	163%

<sup>20</sup> Annex IV of the AIFMR.

<sup>21</sup> ESMA Statistical Report 2020, pp. 7 and 10.

<sup>22</sup> Ibid., p. 11.

<sup>23</sup> Ibid., p. 6.



Borrowing (% of NAV)	1%	8%	284%	3%	5%	21%
<b>Liquidity</b>						
Open ended (% of NAV)	71%	52%	78%	5%	69%	65%
Monthly portfolio liquidity (% of NAV)	77%	4%	39%	0%	85%	61%
Monthly investor liquidity (% of NAV)	70%	16%	28%	3%	74%	61%

Note: All values at end of 2018, AIFs reported to ESMA by NCAs. Statistics for All AIFs also include 512 funds with no predominant type. CIU=collective investment units; PA=Physical assets; IRD=Interest rate derivatives; S=Securities.  
Sources: AIFMD database, national competent authorities, ESMA.

*Source: ESMA 2020 Annual statistics on AIFs, page 7*

The ownership of AIFs assets tends to be concentrated: the top five investors account for about 75% of NAV on average.<sup>24</sup> This pattern applies across AIF types, except for private equity funds, which tend to have less concentrated investor profiles. One possible explanation for such a high degree of ownership concentration in the EU AIF sector is that professional investors tend to be the main investors in AIFs and they typically hold large stakes in funds they invest in.<sup>25</sup> When non-UCITS funds set up under the national law were later captured by the AIFMD and qualified as AIFs this produced a picture of a highly concentrated AIF market.

As regards investor categories, professional investors account for around 84% of AIFs' NAV, while the retail investors account for the remaining 16%. Retail clients' participation in the alternative investment market appears more significant in segments such as real estate and funds of funds where retail investors account for 21% and 30% of the NAV respectively.<sup>26</sup> It is observed that since 2013, both institutional and retail clients have been increasingly migrating away from traditional actively managed strategies towards low-fee passive strategies or alternative asset classes.<sup>27</sup>

In terms of leverage<sup>28</sup>, based on the reported outcomes under the gross and commitment methods of the AIFMR, most AIFs do not appear to engage substantial leverage with the exception of hedge funds. Comparing ESMA statistics for 2017 and 2018, leverage was stable for most types of AIFs, except for hedge funds. Hedge funds gross leverage has reportedly increased from 730% to 1050% between 2017 and 2018, which is partly explained by the

<sup>24</sup> Ibid., p. 11.

<sup>25</sup> Ibid., pp. 5 and 12.

<sup>26</sup> Ibid., p. 7.

<sup>27</sup> McKinsey&Company, *The state of the European asset management industry 2017*, November 2018, p. 12. Retrieved from: <https://www.mckinsey.com/~/media/McKinsey/Industries/Financial%20Services/Our%20Insights/Full%20speed%20ahead%20in%20European%20asset%20management/The-state-of-European-asset-management-2017-web-final.ashx>.

<sup>28</sup> Article 4(1)(v) of the AIFMD defines leverage as 'any method by which an AIFM increases exposure of an AIF it manages whether through borrowing of cash or securities, or leverage embedded in derivative positions or by any other means'.

reliance of some strategies on derivatives.<sup>29</sup> Data shows that hedge funds use synthetic leverage through derivatives, in particular interest rate derivatives<sup>30</sup>, as opposed to financial leverage (borrowing of money to acquire assets), although the latter stood at 160% of the NAV at the end of 2018.<sup>31</sup>

It also is noteworthy that the hedge fund market is also composed of non-EU AIFs, which are marketed almost exclusively to professional investors (98%) in individual Member States through national private placement regimes.<sup>32</sup> ESMA concludes that 40% of investors investing through national private placement regimes cannot be identified.<sup>33</sup> At the end of 2018 the NAV of hedge funds marketed in the Union by the EU AIFMs stood at € 333 billion.<sup>34</sup> Non-EU Hedge funds marketed by non-AIFMs through national private placement regimes in 2018 had a NAV of € 463 billion.<sup>35</sup> The UK is the main domicile for hedge funds with more than 80% of the NAV managed by the UK based AIFMs.<sup>36</sup> Also, according to 2018 ESMA data, the majority of hedge funds are domiciled in the Cayman Islands and marketed in the UK.<sup>37</sup>

As regards liquidity mismatches, in most EU AIFs they are not significant. However, it is observed that certain open-ended AIFs, such as real estate and private equity funds, invest in inherently less liquid assets, such as physical properties or securities of private (un-listed) companies, with the result that some cases exhibit maturity mismatches.<sup>38</sup> According to the liquidity profile of these AIFs, investors are entitled to redeem 28% of the NAV within a day, however, only 26% of the assets could be liquidated to meet these redemption requests.<sup>39</sup>

#### *b) Impact of the AIFMD on investor access*

The marketing passport allows an EU AIFM, authorised in its home Member State, to manage an AIF in other Member States and to market units or shares of EU AIFs it manages to professional investors resident in other Member States under the freedom to provide services or by establishing a branch.<sup>40</sup> Individual Member States may permit marketing of AIFs to retail investors within their own jurisdiction and impose additional conditions as they deem fit.<sup>41</sup>

The size of the European cross-border investment funds market has grown substantially from EUR 2.4 trillion or 40% of total net assets of the European funds (UCITS and AIFs) in 2008 to EUR 6.5 trillion, or 46% of the total fund market in 2018.<sup>42</sup> This growth includes round-trip funds.<sup>43</sup> According to Table 2, 76% of AIFs have access to the EU passport. Among these

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<sup>29</sup> ESMA Statistical Report 2020, p. 9.

<sup>30</sup> Ibid., p. 41.

<sup>31</sup> Ibid., p. 12.

<sup>32</sup> Ibid., pp. 22 and 31.

<sup>33</sup> Ibid., p. 31.

<sup>34</sup> Ibid., p. 21.

<sup>35</sup> Ibid.

<sup>36</sup> Ibid., p. 10.

<sup>37</sup> Ibid., p. 31.

<sup>38</sup> Ibid., p.12.

<sup>39</sup> Ibid.

<sup>40</sup> Articles 31 and 32 of the AIFMD.

<sup>41</sup> Article 43 of the AIFMD.

<sup>42</sup> ECB statistics presented in EFAMA Fact Book 2019, p.11.

<sup>43</sup> Where an AIFM domiciles a fund in another Member State and then distributes it only back into the market where the AIFM is based.

funds, real estate funds have the greatest access to the EU passport with 82% capable of being marketed across the Union.

More detailed analysis indicates that the proportion of AIFs that are registered for sale in two or more Member States other than the fund domicile, i.e. when the AIFM passport is actually put to use, is much lower than for UCITS. In June 2017, only 3% of AIFs were marketed in other Member States<sup>44</sup> with that share almost doubling to 5.8% by October 2019.<sup>45</sup> The AIFMD is a fairly recent legal framework in comparison to the veteran UCITS Directive, which was first adopted in 1985<sup>46</sup>. Feedback from stakeholders and the European Commission's recent work to improve cross-border distribution of investment funds indicated a number of possible reasons why the cross-border activities of AIFMs are more modest.<sup>47</sup> Regulatory barriers were mentioned as a significant disincentive to cross-border distribution including (national) marketing restrictions, regulatory fees, administrative and notification requirements. Some of those issues also featured in the responses of the stakeholders to the General Survey.

Different interpretations of the AIFMD marketing rules as well as additional national marketing requirements were cited by 76% of respondents as a major concern.<sup>48</sup> In particular, it is not cost efficient to be unable to implement a single marketing plan throughout the EU.<sup>49</sup> In this respect, there have been calls to further streamline marketing requirements for AIFs marketed to professional investors and simplify the notification procedure.<sup>50</sup> Moreover, smaller AIFMs reported a decrease in a commercial desire to operate as AIFM.<sup>51</sup>

As regards access to retail investors, the respondents provided mixed views: 44% reported an increased investment from this investor group, 22% observed no change and 22% reported a strong decrease.<sup>52</sup> The cost of complying with the AIFMD and investment restrictions imposed by some Member States for AIFs targeting retail investors were cited by some as an impediment to marketing AIFs to retail investors.<sup>53</sup> Nevertheless, about 40% of the respondent AIFMs market their EU AIFs to EU retail or semi-professional investors.<sup>54</sup> The majority agreed that following implementation of the AIFMD, the ability to market non-EU AIFs to retail investors had become more restricted (see the section on national private placement regimes).<sup>55</sup>

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<sup>44</sup> Morningstar, June 2017 used in the European Commission analyses of the cross-border distribution of investment funds in the EU in Impact Assessment (IA), see *infra* 50.

<sup>45</sup> Morningstar, October 2019.

<sup>46</sup> Council Directive 85/611/EEC of December 1985 on coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), OJ L 375, 31.12.1985, p. 3.

<sup>47</sup> Commission staff working document Impact Assessment on cross-border distribution of collective investment funds, SWD(2018) 54 final, 12.3.2018, [[https://ec.europa.eu/info/law/better-regulation/initiatives/ares-2017-3132069\\_en#pe-2018-1277](https://ec.europa.eu/info/law/better-regulation/initiatives/ares-2017-3132069_en#pe-2018-1277)]. The Commission endeavored to address these issues in a Cross-border distribution of collective investment undertakings, see *infra* 69.

<sup>48</sup> *Ibid.*, pp. 74 and 114.

<sup>49</sup> *Ibid.*, p. 75.

<sup>50</sup> Written submissions following the EGESC meeting of 27.09.2019.

<sup>51</sup> KPMG Report, p. 101.

<sup>52</sup> *Ibid.*, p. 111.

<sup>53</sup> *Ibid.*

<sup>54</sup> *Ibid.*, p. 100. The category of semi-professional investors is not currently defined in the Union's *acquis* and the scope of it is not clear.

<sup>55</sup> KPMG Report, p. 102.

A study on distribution systems for retail investment products sampled distributors across the selected Member States to map products and distribution channels for retail investors with an investment of up to € 100,000.<sup>56</sup> It was found that in continental Europe typically such investors cannot access investment fund managers directly and so normally obtain information on investment products from the end-client distributors such as banks or insurance companies. There has been an identified trend of these financial intermediaries mostly promoting in-house products with only a modest number of third party funds on offer. It is only the financial institutions in the UK that actively offer third party funds. Over the last year, cultural habits and the ban on inducements have led to a noticeable shift towards independent financial advisors (mainly in the UK and the Netherlands) and execution-only online platforms.<sup>57</sup>

In addition to the mentioned traditional fund distribution channels, AIFs are increasingly being distributed through fund supermarkets, online brokers and banks' online platforms targeting self-directed individuals who are knowledgeable enough to trade by themselves.<sup>58</sup> These can be found in almost all European Member States with Germany and the UK having the most developed markets in this respect.<sup>59</sup> Offering online investment products means the platforms are subject to the revised Directive on Markets in Financial Instruments (MiFID II) which aims to ensure that investors only buy products that are suitable for them.<sup>60</sup>

The study concludes that on-line investing benefits retail investors in terms of lower costs of investing, easier access to a wider choice of products and the availability of additional services relating to product comparison or education about investment activities.<sup>61</sup> Potential downsides include insufficient suitability checks and increased risks of potential mis-buying.

However, it is clear that technological developments are bringing investment services closer to investors. Problems on the distribution side remain, particularly the fragmented and complex Union regulatory environment, which fall outside the scope of the AIFMD. These issues are being assessed in other work streams by the European Commission.<sup>62</sup>

Generally, the AIFMD was credited with playing a facilitating role in creating an internal market for AIFs. A majority of the AIFMs responding to the General Survey, public authorities and institutional investors reported that access to national markets had increased due to the AIFMD although 34% also reported an increased time to market.<sup>63</sup> 65% of the respondent AIFMs market their AIFs to other Member States.<sup>64</sup> Approximately 25% of the respondent AIFMs indicated that their willingness or ability to access markets of other Member States had increased. 45% experiencing no change in this respect.<sup>65</sup>

The market data combined with the feedback from stakeholders allows concluding that the AIFMD has had a positive impact on the development of internal market for EU AIFs.

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<sup>56</sup> Study on the distribution systems of retail investment products across the European Union, April 2018, p.17; [https://ec.europa.eu/info/sites/info/files/180425-retail-investment-products-distribution-systems\\_en.pdf](https://ec.europa.eu/info/sites/info/files/180425-retail-investment-products-distribution-systems_en.pdf)

<sup>57</sup> Ibid., p. 27.

<sup>58</sup> Ibid., p. 120.

<sup>59</sup> Ibid., p. 122.

<sup>60</sup> Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU, OJ L 173, 12.6.2014, pp. 349 - 496.

<sup>61</sup> Supra 62, p. 125.

<sup>62</sup> Completing CMU is a priority for this Commission. See High Level Forum on Capital Markets Union.

<sup>63</sup> KPMG Report, p. 101.

<sup>64</sup> Ibid., p. 100.

<sup>65</sup> Ibid., p. 101.

However, the effectiveness of the AIFM passport is limited by diverging interpretations of the AIFMD and additional national requirements imposed by the Member States to those in the AIFMD.

In response, the European Commission, proposed a Cross-Border Investment Fund Distribution package to improve the regulatory environment for EU AIFMs.<sup>66</sup>

The Cross-Border Fund Distribution legislative package entered into force on 31 July 2019 and will be applicable upon its implementation into national legal systems by August 2021. The Package contains the following main improvements by:

- making it easier for EU AIFMs to test the appetite of potential professional investors in new markets (so-called ‘pre-marketing’). This will help AIFMs to make more informed commercial decisions before entering a new market;
- clarifying customer service obligations for asset managers in their host Member State. This should ensure that investors have access to a uniform, high-level customer service across the EU without imposing the cost of maintaining a physical presence on investment fund managers;
- aligning the procedures and conditions to exit national markets when investment fund managers decide to terminate the offering or placement of their funds (so-called de-notification procedure); and,
- introducing increased transparency and a single online access point to information on national rules related to marketing requirements and applicable supervisory fees, which will help reduce the legal and administrative cost of cross-border activities for investment fund managers in the Union.

### 2.1.2 Single Market for non-EU AIFs

#### a) *AIFMD passport for third country AIFMs and AIFs*

The AIFMD aims to create an internal market for non-EU AIFMs and non-EU AIFs. It envisages the possibility to extend the AIFMD passport to funds and managers established in third countries, enabling non-EU AIFMs to offer their management services and market their AIFs to professional investors throughout the Union. Most of the rules<sup>67</sup> specific to non-EU AIFMs and non-EU AIFs still needs to be activated by the European Commission’s delegated act.<sup>68</sup> The delegated act needs to approve foreign jurisdictions as acceptable domiciles for

<sup>66</sup> Directive (EU) 2019/1160 of the European Parliament and of the Council of 20 June 2019 amending Directives 2009/65/EC and 2011/61/EU with regard to cross-border distribution of collective investment undertakings, OJ L 188, 12.7.2019, pp. 106–115 and Regulation (EU) 2019/1156 of the European Parliament and of the Council of 20 June 2019 on facilitating cross-border distribution of collective investment undertakings and amending Regulations (EU) No 345/2013, (EU) No 346/2013 and (EU) No 1286/2014, OJ L 188, 12.7.2019, pp. 55-66.

<sup>67</sup> Articles 35, 37 to 41 of the AIFMD.

<sup>68</sup> Article 67 of the AIFMD.

AIFMs and AIFs in terms of investor protection, market disruption, competition and monitoring of systemic risk, thus enabling their access to the internal market. In this respect, ESMA is required to provide the European Parliament, the Council and the European Commission with an advice.<sup>69</sup>

In 2015 and 2016 ESMA carried out an assessment of twelve foreign jurisdictions<sup>70</sup> evaluating whether activating the third country passport for the entities based in those jurisdictions could undermine investor protection, distort competition or impede monitoring of systemic risks. The advice was addressed to the EU co-legislators and the European Commission<sup>71</sup> with a particular emphasis on the regulatory/supervisory frameworks and practices of the assessed jurisdictions.<sup>72</sup> Aspects falling outside the remit of ESMA's competences, like tax and anti-money laundering (AML) or wider Union policy considerations, are being assessed by the European Commission to complete the requisite analysis.<sup>73</sup>

Given that the delegated act has not yet been adopted and the passport for the third country entities is not available, the European Commission is unable to appraise the efficacy of the relevant AIFMD provisions. Nevertheless, some stakeholders, in particular those based in offshore jurisdictions, support the third country regime being activated<sup>74</sup>, whereas those based in the main trading partners of the EU, such as the USA or Japan, have expressed their preference for national private placement regimes, which are currently used to access markets of individual Member States.<sup>75</sup>

#### *b) National Private Placement Regimes (NPPR)*

An authorisation granted by a Member State to a non-EU AIFM or AIF under the national private placement regimes is valid in the authorising Member State only and must meet the minimum standards set out in the AIFMD<sup>76</sup>. Some Member States choose not have such national rules.<sup>77</sup> Some respondents indicated that the obligations under some NPPRs are considered to be difficult to use or expensive.<sup>78</sup>

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<sup>69</sup> Article 67 AIFMD.

<sup>70</sup> Guernsey, Jersey, Hong Kong, Singapore, Switzerland, United States of America, Australia, Bermuda, Canada, Cayman Islands, Isle of Man and Japan.

<sup>71</sup> ESMA Advice to the European Parliament, the Council and the European Commission on the application of the AIFMD passport to non-EU AIFMs and AIFs, ESMA/2015/1236 of 30 July 2015 and ESMA/2016/1140 of 12 September 2016.

<sup>72</sup> Switzerland, Guernsey and Jersey, Hong Kong, Singapore, Canada, Australia and Japan received a positive advice. The USA was positively appraised with caveats. Isle of Man, Cayman Islands and Bermuda was incomplete.

<sup>73</sup> Following the adoption of the 4th Anti-Money Laundering Directive (Directive (EU) 2015/849 of the European Parliament and of the Council of 20 May 2015 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, amending Regulation (EU) No 648/2012 of the European Parliament and of the Council, and repealing Directive 2005/60/EC of the European Parliament and of the Council and Commission Directive 2006/70/EC, OJ L 141, 5.6.2015, p. 73-117), the Commission is tasked to establish its own list of third country jurisdictions with strategic deficiencies in their anti-money laundering (AML) and countering financing of terrorism (CFT) regimes.

<sup>74</sup> Replies to Call for Evidence #240, 450, 3755, 3781. KPMG Study p. 102.

<sup>75</sup> Reply to Call for Evidence #3416. KPMG Study p. 102.

<sup>76</sup> Articles 36 and 42 of the AIFMD.

<sup>77</sup> At the end of Q5 2015 the national legislation of Croatia, Latvia, Italy, and Poland did not allow marketing of non-EU AIFs by EU AIFMs in accordance with Article 36(1) AIFMD. The same Member States plus Greece and Hungary did not allow marketing of AIFs by non-EU AIFMs in accordance with Article 42(1) AIFMD. ESMA Opinion to the European Parliament, Council and Commission and responses to the call for evidence on the functioning of the AIFMD EU passport and of the National Private Placement Regimes, 30 July 2015,

Where a Member State allows an EU AIFM to offer in its territory a non-EU AIF, the AIFM remains subject to all the requirements of the AIFMD with a certain flexibility regarding the appointment of a depository. Member States may apply lighter obligations for such depositories but they may also impose stricter rules as they see fit. Either way, a minimum requirement for the AIFMs concerned is to appoint an entity to safe-keep non-EU AIFs assets, monitor the fund's cash flows and perform oversight functions.<sup>79</sup>

If a Member State permits non-EU AIFMs to offer AIFs in its territory, the AIFMs must comply with the limited number of the AIFMD provisions on reporting and disclosure obligations as well as with the rules regarding investing in non-listed companies.<sup>80</sup>

In both cases, the Directive requires that appropriate cooperation arrangements for the purposes of systemic risk oversight and in line with international standards, are in place between the NCA of the relevant Member State and the supervisory authorities of the respective third country where the non-EU AIF or non-EU AIFM is established.<sup>81</sup> Moreover, the third country cannot be listed as Non-cooperative Country and Territory by Financial Action Task Force (FATF).<sup>82</sup>

A majority of respondents to the General Survey did not express an opinion about the impact of the AIFMD on the marketing of non-EU AIFs into the EU.<sup>83</sup> Those who did, indicated that following the AIFMD application, restrictions on the type of non-EU AIFs that can be marketed into the EU have increased, the ability to market to retail investors has become more restricted and that approvals under NPPRs take longer.<sup>84</sup> Nevertheless, a significant number of Member States and third countries have called for the NPPRs to be retained even if the non-EU passport is activated.<sup>85</sup>

Some Member States, however, draw attention to the effect that NPPRs have on level playing field for EU AIFMs, which comply with the AIFMD in its entirety. To address the fragmented landscape of NPPRs, some Member States suggest their harmonisation<sup>86</sup> and others consider that activating the third country passport regime, followed by a phasing-out of NPPRs, would address this issue.<sup>87</sup> In the meantime, it is important to recall the role that NPPRs have played in facilitating international capital flows and investor access to a broader range of products.

The AIFMD provisions concerning NPPRs allowed the uninterrupted marketing of non-EU AIFs in individual Member States, which had been permitting such imports in their territories before adoption of the AIFMD. The EU-wide 2015 statistics demonstrate a consistent

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ESMA/2015/1235, para. 30. Replies to Call for Evidence #90 and #2789. NPPRs of Germany and France are considered to be difficult to use or prohibitively expensive, see Stephan Sims, Patrick Brandt and Greg Norman, *AIFMD Passport: Europe must try harder*, Journal of Investment Compliance, Vol 17, No 2, 2016, p.15.

<sup>78</sup> Stephan Sims, Patrick Brandt and Greg Norman, *AIFMD Passport: Europe must try harder*, Journal of Investment Compliance, Vol 17, No 2, 2016, p.15.

<sup>79</sup> As stipulated in points (7) to (9) of Article 21 of the AIFMD.

<sup>80</sup> Articles 22-24 of the AIFMD and Articles 26-30, if Article 26 applies.

<sup>81</sup> Articles 36(1)(b) and 42(1)(b) of the AIFMD.

<sup>82</sup> Articles 36(1)(c) and 42(1)(c) of the AIFMD.

<sup>83</sup> KPMG Report, p. 102.

<sup>84</sup> Ibid.

<sup>85</sup> Ibid.

<sup>86</sup> EGESC meeting of 27.09.2019.

<sup>87</sup> Ibid.

increase in AIFMs authorised to market non-EU AIFs<sup>88</sup> and in marketed non-EU AIFs<sup>89</sup> under the NPPRs. At the end of 2018, the total regulatory asset under management of uniquely identified AIFs reached € 10.3 tn for the NPPR market; the NAV of the NPPR market stood at € 1.7 tn.<sup>90</sup> These figures make up one-fifth of the overall EU AIFs market.<sup>91</sup> NPPR fund marketing is concentrated in a small number of member states and 98% of investors are professional investors. Country level data, however, exposes significant differences in terms of marketed AIFs across national markets regardless of the local requirements applied on top of the minimum standards imposed by the AIFMD.<sup>92</sup>

Investor disclosure and reporting requirements, which apply equally to EU AIFs and non-EU AIFs marketed under the NPPRs, are judged to be relevant for investor protection and for informing NCAs in their monitoring of systemic risk, including risks arising outside the EU.<sup>93</sup> According to the data reported under the AIFMD, hedge funds marketed under the NPPRs are highly leveraged with most established in third countries.<sup>94</sup> Consequently, access to the reported data permits NCAs to develop a more comprehensive picture of the risks posed by EU and non-EU AIFMs on behalf of their managed AIFs and of their potential effects on the broader financial system.

As a result it can be concluded that NPPRs played a bridging role, albeit by creating an unlevel playing field for EU and non-EU AIFMs. In the absence of the ESMA opinion and advice on the phasing out of NPPRs,<sup>95</sup> the supervisory reporting requirements applicable to the imported AIFs will continue providing important data to the EU supervisors for monitoring risks to the financial system.

## **2.2 AIFMD impact on AIFMs**

The AIFM passport to manage and market AIFs was intended to dismantle the remaining barriers to collective investment management in the Union while at the same time ensuring adequate investor protection and coherent supervisory oversight of the AIF sector. The AIFMD established a foundation for a more harmonised and stringent regulatory and supervisory framework for AIFMs.<sup>96</sup>

### **2.2.1 Harmonised framework for EU AIFMs**

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<sup>88</sup> ESMA Opinion to the European Parliament, Council and Commission and responses to the call for evidence on the functioning of the AIFMD EU passport and of the National Private Placement Regimes, 30 July 2015, ESMA/2015/1235, para. 32 and 36.

<sup>89</sup> Ibid., para. 33 and 37.

<sup>90</sup> Regulatory AuM includes the value of all assets in the portfolio, including through the use of leverage by outright borrowing of cash and securities and leverage embedded in derivatives and (ii) the ratio of gross exposures excluding IRDs to NAV. ESMA Statistical Report 2020, p. 31.

<sup>91</sup> ESMA Statistical Report 2020, p. 31.

<sup>92</sup> KPMG Report, pp. 251-252.

<sup>93</sup> Ibid., pp. 252-254.

<sup>94</sup> According to the data reported to ESMA, NAV of HF marketed under NPPR represent EUR 200 bn, whereas EU based HF sector account for EUR 30 bn only (31%). Only 6.7% of the NAV is managed by a manager located in the EU (mainly UK). However, looking at the ECB data, end of 2017 HF had a NAV around EUR 407, comprising € 108bn for AIFs and € 299bn for UCITS. These divergences are explained by different definition of a HF. ESMA Statistical Report, pp. 21, 44, 46 and 47.

<sup>95</sup> Article 68 of the AIFMD requires ESMA issuing an advice to the European Parliament, the Council and the Commission on the termination of the existence of the NPPR.

<sup>96</sup> KPMG Report, p. 22.



### a) Authorisation/registration requirements

One of the main objectives of the AIFMD is to monitor and mitigate macro and micro risks that stem from the activities of AIFMs.<sup>97</sup> In practical terms, this requires identification of the relevant entities, which should meet the basic requirements enabling them to professionally and responsibly manage collective investments for the benefit of investors. The EU legislation sets thresholds for assets under management (AuM) above which the activities of AIFMs may pose significant systemic risk and impose additional requirements on those AIFMs.

According to the AIFMD, AIFMs that manage portfolios of AIFs exceeding € 100 million of AuM and that use leverage shall be authorised by the NCA of its home Member State and must comply with all the requirements of the AIFMD.<sup>98</sup> For the AIFMs that do not use leverage, the threshold is raised to € 500 million.<sup>99</sup> According to the Directive, the request for authorisation must be processed within three months provided a complete application has been submitted. NCAs can extend this period for a further three months if necessary and after having notified the AIFM.<sup>100</sup>

Member States must ensure that AIFMs managing AIFs beneath the thresholds, instead of being fully licenced under the Directive, are at least registered with the NCA and report on their principle exposures and most important concentrations for the purposes of system risk monitoring. Member States have a wide discretion on whether to impose stricter requirements<sup>101</sup> on smaller fund managers. A number of Member States chose to adopt stricter rules for the sub-threshold AIFMs in some cases simply continuing to apply national rules that had been in place before the AIFMD adoption.<sup>102</sup>

One-quarter of all respondents to the General Survey considered that there is no significant differentiation in the national laws governing smaller and larger AIFMs, despite such a possibility being provided for in the AIFMD.<sup>103</sup> Academic literature similarly questions the proportionality of the registration regime, as elaborated in the AIFMR<sup>104</sup>, where supervisory reporting requirements are for the most part the same for all AIFMs regardless of the size of their activities.<sup>105</sup>

Another criticism drawn by the interviewees of the General Survey and by the respondents to the Call for Evidence concerned the level of regulatory fees charged by NCAs. Respondent NCAs indicated that they charge an average of € 8,300 for a full-scope AIFM licence with the maximum average being € 10,900.<sup>106</sup> It was noted that smaller market participants are likely to be more affected by the fees than their larger competitors.<sup>107</sup> One interviewee's call for a harmonised supervisory fee regime was supported by some Member States.<sup>108</sup> In terms of

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<sup>97</sup> Recital 2 of the AIFMD.

<sup>98</sup> Article 3(2)(a) of the AIFMD.

<sup>99</sup> Article 3(2)(b) of the AIFMD.

<sup>100</sup> Article 8(5) of the AIFMD.

<sup>101</sup> Article 3(3) of the AIFMD.

<sup>102</sup> KPMG Report, pp. 134-138 examining regulation in MT, IRL, DE, FR, NL, UK, LUX.

<sup>103</sup> Ibid., p. 143.

<sup>104</sup> Articles 5 and 110 of the AIFMR.

<sup>105</sup> Dirk Zetsche, *The Alternative Investment Fund Managers Directive*, Second Edition, Kluwer Law International, 2015, p. 81.

<sup>106</sup> KPMG Report, p. 147. For more granular information on the one-off and ongoing regulatory fees see the Commission Impact Assessment supra 50, p. 22.

<sup>107</sup> KPMG Report, p. 148.

<sup>108</sup> Ibid p. 149.

procedural efficiency, according to the General Survey, 60% of the AIFMs were authorised within six months, which is the maximum set forth by the AIFMD while 10% waited over a year.<sup>109</sup>

Bringing AIFMs (and indirectly AIFs) under supervisory oversight is important for system-wide macro-prudential monitoring.<sup>110</sup> Competent authorities now possess and analyse data reported by AIFMs. This broader overview of market developments enables supervisors to provide early warnings of potential macroeconomic and financial risks and take action to address them. For example, the ESMA Annual Statistical Report, which covers activities of AIFMs managing small and large AIFs in terms of their net asset value, signals potential liquidity risks in the real estate segment of the EU AIF market.<sup>111</sup> There is also a suggestion from a national supervisor to reassess the AIFMD capital requirements by making them more risk-sensitive given the € 10 mil cap regardless of the size of the managed portfolio or any auxiliary services that the AIFMs may provide.

The AIFMD provides for national discretion to maintain lighter rules for smaller AIFMs and this is deemed to be in line with the principle of proportionality.<sup>112</sup> It is true, however, that some Member States choose to apply the AIFMD in its entirety regardless of the volume of the assets managed by the AIFM. In particular, it is considered burdensome for smaller AIFMs to comply with the regulatory reporting requirements (although with a lesser frequency) to the same extent as the larger AIFMs (this is discussed in further detail in section 3.4.1 a) on reporting requirements). Nevertheless, some discretion in this respect exists within the AIFMD and may be implemented by the Member States.

The problem is more acute with regard to smaller AIFMs that would like to operate across the Union but find it too burdensome to comply with all the requirements of the AIFMD. Some Member States restrict the activities of sub-threshold AIFMs, unless they opt into a full application of the AIFMD, such as preventing such funds from enjoying the benefits of internal market and there some respondents called for greater harmonisation of the rules for smaller AIFMs.<sup>113</sup>

As regards the costs for obtaining the AIFM licence, regulatory fees and other costs were considered as an obstacle by the industry but did not appear to deter AIFMs from entering the market.<sup>114</sup> This issue has been analysed in depth when preparing the European Commission proposal for a Regulation on facilitating cross-border distribution of collective investment funds.<sup>115</sup> While the complete harmonisation of regulatory fees was not deemed to be attainable at the time, the adopted Regulation (EU) 2019/1156 aims to bring about more proportionality and transparency into the process of regulatory fees calculation in each Member State, which should go some way towards addressing industry concerns.<sup>116</sup>

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<sup>109</sup> Article 8(5) of the AIFMD, KPMG Report p. 147.

<sup>110</sup> See the section on regulatory reporting.

<sup>111</sup> ESMA Statistical Report, p.19.

<sup>112</sup> KPMG Report, p. 149. EGESC meeting of 27.09.2019.

<sup>113</sup> Ibid., pp. 101 and 142. EGESC of 27.09.2019.

<sup>114</sup> Ibid., p. 147.

<sup>115</sup> Supra 47.

<sup>116</sup> Articles 9 - 11 of Regulation (EU) 2019/1156 of the European Parliament and of the Council of 20 June 2019 on facilitating cross-border distribution of collective investment undertakings and amending Regulations (EU) No 345/2013, (EU) No 346/2013 and (EU) No 1286/2014, OJ L 188, 12.7.2019, p. 55–66.

It follows from the foregoing that the AIFMD rules concerning registration or authorisation of AIFMs are necessary for enabling supervisors to conduct macro-prudential monitoring and are proportionate in terms of their scope of application with a possible rationalisation of supervisory reporting requirements for smaller AIFMs.

#### *b) Remuneration*

Rules governing remuneration of AIFMs were introduced in the AIFMD to promote effective and sound risk management by aligning pay incentives with sustainable performance.<sup>117</sup> These rules implement the principles laid down in the European Commission's Recommendation on remuneration policies in the financial services sector, which primarily concern EU firms operating under different EU legal frameworks, including UCITS, AIFMD, CRD/CRR or MiFID II.<sup>118</sup> Besides recognising that separating risk management from business units is necessary to preserve the effectiveness of the risk control function of financial firms, the Recommendation challenges incentives that may reward excessive risk-taking in the short-term while disregarding the potential for higher losses in the longer term.<sup>119</sup>

Following the Recommendation, the AIFMD laid down requirements for AIFMs to put sound remuneration policies and practices in place and review them periodically.<sup>120</sup> A number of principles apply when setting remuneration for employees deemed risk takers and their supervisors.<sup>121</sup> For example, the performance of a particular employee must be assessed in a multi-year framework by taking into account redemption policy of the AIF and its investment risks.<sup>122</sup>

Where staff compensation includes fixed and variable remuneration, the former component must be at such a level that would allow the exclusion of any payment of the variable component.<sup>123</sup> To better align interests of AIFM and investors, at least 50% of the variable remuneration must be paid in units or shares of the managed AIF or equivalent ownership instruments or share-linked instruments.<sup>124</sup> At least 40% of the variable remuneration must be deferred for at least three years (unless the life cycle of the AIF concerned is shorter).<sup>125</sup> Larger AIFMs must have a remuneration committee for preparing decisions related to staff compensation by considering incentives to effectively manage risks.<sup>126</sup>

Half of the AIFMs responding to the General Survey stated that following the implementation of the AIFMD the fixed component of the relevant staff's remuneration has increased in comparison to the variable component.<sup>127</sup> Some interviewed AIFMs argued that such a compensation model is more expensive because the interests of investors and AIFM staff are less aligned and the fixed costs increase. There have also been complaints about the lack of

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<sup>117</sup> Recital 24 of the AIFMD; Recital 7 of Commission Recommendation of 30 April 2009 on remuneration policies in the financial services sector, OJ L 120/22, 15.05.2009.

<sup>118</sup> Commission Recommendation of 30 April 2009 on remuneration policies in the financial services sector, OJ L 120/22, 15.05.2009.

<sup>119</sup> *Ibid.*, Recitals 3-5.

<sup>120</sup> Article 3 and Annex II of the AIFMD.

<sup>121</sup> Annex II of the AIFMD.

<sup>122</sup> Point 1(h) of Annex II of the AIFMD.

<sup>123</sup> Point 1(j) of Annex II of the AIFMD.

<sup>124</sup> Point 1(m) of Annex II of the AIFMD.

<sup>125</sup> Point 1(n) of Annex II of the AIFMD.

<sup>126</sup> Point 3 of of Annex II of the AIFMD.

<sup>127</sup> KPMG Report, p. 188.

clarity on how to apply remuneration rules where firms belong to corporate groups or conglomerates combining credit institutions, investment firms and investment fund managers.<sup>128</sup>

A reported shift from variable towards fixed remuneration<sup>129</sup> seems to have introduced more risk-aversion in the collective alternative investment management sector and overall increased awareness of proper remuneration systems.<sup>130</sup> It can be concluded that the adopted rules have had the desired effect on the behaviour of the targeted agents as envisaged by EU legislation. There was no evidence found, that the AIFMD remuneration rules have been applied to the detriment of investors. Despite the absence of evidence challenging the effectiveness of the AIFMD remuneration rules, this part of the AIFMD may need to be revised to take into account recent amendments to other sectorial legislation.

The above-mentioned Recommendation states that in order to avoid regulatory arbitrage rules on remuneration should be the same across different sectors of the financial services industry. For this reason, recent changes to the CRD<sup>131</sup>/CRR<sup>132</sup> legal framework *inter alia* concerning compensating risk-taking staff in credit institutions may require adjustments in the AIFMD rules. For example, clarifying the measure of ‘proportionality’. The CRD was amended to exempt in clear terms small institutions and staff with low levels of variable remuneration from the principles on deferral and pay-out in instruments.<sup>133</sup> It also provides clear criteria for identifying those small institutions as well as low levels of variable remuneration.<sup>134</sup>

One issue raised by the stakeholders has been addressed with the reviewed CRD, which now provides that AIFMs belonging to the same corporate group or conglomerate will have to apply the AIFMD rules on remuneration thus avoiding their being subject to multiple sets of rules regulating different financial intermediaries.<sup>135</sup>

### *c) Delegation regime*

Delegation is a tool used by CIU managers for various reasons including optimising business processes, seeking specific expertise or to sometimes exploiting regulatory arbitrage opportunities.<sup>136</sup> With particular regard to the latter, the EU legislature has sought to avoid creating conditions for a race to the bottom with other jurisdictions in terms of regulatory standards.<sup>137</sup> Therefore, whilst the AIFMD permits AIFMs to delegate to third parties portfolio management or risk management, it also contains a number of safeguards subject to supervisory assessment.

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<sup>128</sup> Ibid., p. 191. Multiple stakeholder submissions in this respect before the Commission and ESMA.

<sup>129</sup> Ibid., pp. 188-189.

<sup>130</sup> Ibid., p. 192.

<sup>131</sup> Directive (EU) 2019/878 of the European Parliament and of the Council of 20 May 2019 amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures, OJ L 150, 7.6.2019, p. 253.

<sup>132</sup> Regulation (EU) 2019/876 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements, and Regulation (EU) No 648/2012, OJ L 150, 7.6.2019, pp. 1 - 225.

<sup>133</sup> Article 94 (3) of Directive 2019/878.

<sup>134</sup> Article 94 (4) of Directive 2019/878.

<sup>135</sup> Article 109 (4) of Directive 2019/878.

<sup>136</sup> Eddy Wymeersch, *Brexit and the Provision of Financial services into the EU and into the UK*, ECFR 4/2018, p. 738.

<sup>137</sup> Supra 111, p. 269.

The AIFMD and the AIFMR lay down detailed requirements for the delegate and obligations of the delegating AIFM as well as its remaining liability towards the managed AIF and investors.<sup>138</sup> The core functions of AIFMs can be delegated only to undertakings registered or authorised for asset management and supervised by the competent authorities.<sup>139</sup> The delegate must be of good repute, qualified, have sufficient technical and human resources, and possess expertise necessary to discharge vested tasks.<sup>140</sup> Moreover, the AIFM must supervise the delegate and be able to withdraw delegation immediately.<sup>141</sup> Importantly, AIFMs cannot delegate the core functions to depositories or any entity, whose interest may conflict with those of the AIFM or the AIF's investors.

NCAs must be notified before the delegation arrangements become effective so they can assess whether the delegation structure is objectively necessary. These most commonly include optimisation of business functions and costs, seeking expertise of the delegate in specific markets or accessing global trading capabilities.<sup>142</sup> Where a delegate is a third country undertaking, a cooperation agreement between the relevant NCAs must be in place.<sup>143</sup>

AIFMs can no longer be considered as such if they turn into letter-box entities. An entity is no longer considered to be an AIFM where it does not ensure a permanent supervision of the delegate or does not retain the prescribed standard of decision making. As a consequence, the licence of such an AIFM should be rescinded.

The majority of the respondents to the General Survey did not report any material change with respect to their delegation arrangements following the application of the AIFMD.<sup>144</sup> 35% of them delegate portfolio management activities and 10% do so with respect to risk management. Smaller managers were reportedly more likely to delegate portfolio management than larger ones.<sup>145</sup> In France and Luxembourg more than half of all AIFMs delegate portfolio management.<sup>146</sup> 43% of AIFMs reported that the AIFMD resulted in a fee increase for delegated activities.<sup>147</sup>

Given that the AIFMD rules on delegation require AIFMs to frequently monitor the delegate and review delegation arrangements, the increase in costs is deemed justified.<sup>148</sup> Overall, it can be concluded that the AIFMD rules regarding delegation arrangements are proportionate within the imposed limitations. The provided safeguards in place to respond to supervisory and competitive concerns are deemed to equip supervisory authorities with a relevant toolkit.<sup>149</sup> Some respondents call for more harmonised rules on delegation.<sup>150</sup> The effectiveness of the rules on delegation is bound to rest entirely on their diligent enforcement by the supervisory authorities. AIFMs, which appear to host 'empty shells' (engaging in so-

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<sup>138</sup> Article 20(3) of the AIFMD.

<sup>139</sup> Article 20(1)(c) of the AIFMD, Article 78 of the AIFMR.

<sup>140</sup> Article 20(1)(b) and (f) of the AIFMD, Article 77 of the AIFMR.

<sup>141</sup> Article 20(1)(f) of the AIFMD, Article 75(f) of the AIFMR.

<sup>142</sup> This list is not exhaustive. Article 20(1)(a) of the AIFMD and Article 76 of the AIFMR.

<sup>143</sup> Article 20(1)(d) of the AIFMD.

<sup>144</sup> KPMG Report, p. 178.

<sup>145</sup> *Ibid.*, p. 177.

<sup>146</sup> *Ibid.*, p. 178.

<sup>147</sup> *Ibid.*, p. 179.

<sup>148</sup> *Ibid.*

<sup>149</sup> Eddy Wymeersch, *Brexit and the Provision of Financial services into the EU and into the UK*, ECFR 4/2018.

<sup>150</sup> EGESC of 29.09.2019.

called white label business) and delegate all investment management functions abroad, should be properly scrutinized.<sup>151</sup>

#### *d) Auxiliary services provided by AIFMs*

In addition to a collective investment management, licenced AIFMs can seek supplementary authorisation to provide a number of auxiliary services. These include individual portfolio management of investments on a discretionary basis, investment advice, safekeeping and administration in relation to shares and units of CIU and reception and transmission of orders in relation to financial instruments.<sup>152</sup> Where financial instruments are involved, AIFMs are required to comply with the enumerated provisions of the MiFID.<sup>153</sup> Since the adoption of the AIFMD, the MiFID framework has undergone some major changes. Therefore, to ensure level playing field between investment firms and AIFMs where they provide competing services, the AIFMD should be also aligned to cover the relevant obligations as laid down in the MiFID II.

### **2.2.2 Harmonised framework for non-EU AIFMs**

The AIFMD aims to establish common conditions for the non-EU AIFM activities in the Union. Currently the relevant provisions of the AIFMD are not activated and therefore their effects cannot be appraised. The functioning of the national private placement regimes is analysed in the Section 2.1.2.

### **2.3 AIFMD impact on investors**

Studies of the asset management sector has confirmed that countries with better investor protection have larger fund industries where investors enjoy higher returns and lower fund fees.<sup>154</sup> The AIFMD seeks to provide high-level investor protection, while at the same time creating an internal market for AIFs with a wider range of products for the investors to choose from. Even though it was the institutional investors called for an introduction of greater transparency in relation to the offered AIFs, an increased availability of AIFs to retail investors makes a robust framework for AIFMs even more pertinent.

#### **2.3.1 Investor disclosure rules**

Professional investors are deemed to be sophisticated enough to evaluate the merits of an investment proposition and to bear the assumed risks. However, they still need to be provided with correct and relevant information in order to conduct due diligence before investing and to monitor the performance of the investments made. A number of studies carried out before the adoption of the AIFMD indicated dissatisfaction among institutional investors with the lack of transparency from hedge fund managers.<sup>155</sup> The AIFMD addressed this issue by

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<sup>151</sup> ESMA opinion to support supervisory convergence in the area of investment management in the context of the United Kingdom withdrawing from the European Union, ESMA34-45-344, 13.07.2017.

<sup>152</sup> Article 6(4) of the AIFMD.

<sup>153</sup> Article 6(6) of the AIFMD refers to the obligations of Directive 2004/39/EC.

<sup>154</sup> Ajay Khorana, Henri Servaes, Peter Tufano, '*Mutual Fund Fees Around the World*', Oxford University Press on behalf of Society for Financial Studies, v 22, n 3, 19 April 2008, p. 1298.

<sup>155</sup> KPMG Report, pp. 218-219.

identifying the key elements of an investment offer and internal processes of the AIFM that may have an effect on the expected returns and therefore must be disclosed in advance.<sup>156</sup>

According to the AIFMD, AIFMs must make available to prospective investors a description of each managed/marketted AIF's investment strategy, types of assets invested in, applicable investment restrictions, use and restrictions on the use of leverage, delegation arrangements, valuation procedures and pricing methodology, liquidity risk management and redemption policy, all fees, charges and expenses, any preferential treatment for certain investors and the latest annual report. An annual report issued for each financial year may be requested by investors. In addition to financial statements, the annual report must also disclose the amount of remuneration paid to the AIFM's staff and any material changes to the initial information.

The large majority of respondents to the General Survey were of the view that the AIFMD disclosure provisions have overall increased the level of information available to investors.<sup>157</sup> Some observed that the professional investors also request additional information to the mandatory disclosures under the AIFMD or in different formats, suggesting such investors should be able to opt out from the AIFMD requirements.<sup>158</sup> The majority of the respondents indicated that there are some duplications with the disclosure requirements laid down in other legal acts, in particular with MiFID II as regards calculation of fund performance and with the PRIIP KID and MiFID II as regards climate change risk.

The AIFMD objective to harmonise national rules on disclosures to professional investors was largely achieved whilst entailing a certain cost for the industry.<sup>159</sup> The majority of interviewees were of the view that the AIFMD disclosure rules enable investors to make better informed investment decisions.<sup>160</sup> It was not identified, which particular key information as set forth in the AIFMD could be withheld from professional investors and not undermine their understanding of the investment proposition. Based on the collected and analysed information it would seem that the AIFMD increased transparency regarding the offered products and services thus achieving the set objective.

As regards allegations of a potential disclosure duplication under the AIFMD, European Long-term Investment Fund Regulation (ELTIF) and Prospectus Regulation, the relevant provisions take account of the existing requirements and explicitly recognise that the duplication of information must be avoided.<sup>161</sup> Moreover, the PRIIPS Regulation applies when an AIF is offered to retail investors<sup>162</sup> and it is akin to a UCITS KID<sup>163</sup>, which accompanies a UCITS prospectus. The EU legislation considers that retail investors, besides receiving a prospectus on the offered investment fund, must also be provided with a short and clear document containing essential information. This is not considered to be a duplication but a distinct obligation in the interest of the most vulnerable group of investors.

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<sup>156</sup> Articles 22 and 23 of the AIFMD and Articles 103-111 of the AIFMR.

<sup>157</sup> KPMG Report, p. 210.

<sup>158</sup> Ibid., p. 77.

<sup>159</sup> No quantitative data was provided by the respondents to the General Survey to substantiate the cost element of the claim.

<sup>160</sup> KPMG Report, p. 77.

<sup>161</sup> Article 23(3) of the AIFMD, Article 23(3)(c) of Regulation (EU) 2015/760 of the European Parliament and of the Council of 29 April 2015 on European long-term investment funds, OJ L 123, 19.5.2015, pp. 98 - 121.

<sup>162</sup> AIFs using a UCITS KIID benefit from an exemption until 1 January 2022 and do not need to produce a PRIIPs KID.

<sup>163</sup> Eventually to be replaced by the PRIIPS KID.

As regards alleged duplications of calculation of fund performance with respect to climate change risk, in this respect the EU regulation on sustainability related disclosures in the financial services sector is set to improve coherence across the mentioned regulatory frameworks.<sup>164</sup>

### 2.3.2 Conflicts of interest

The AIFMD does not preclude AIFMs from managing multiple AIFs and UCITS funds. Prime brokers are engaged to execute and clear trades, provide financing, custody and other operational and administrative services. Depositories are appointed to safe-keep assets, and to monitor cash flows and compliance with the fund rules (see more on the depositories in Section 2.3.4). In the hedge fund universe, AIFMs rely on prime brokers to utilise derivatives and obtain leverage. This web of relationships may generate conflicts of interest to the detriment of some investors.

For example, where the investment periods and investment policies of several AIFs managed by the same AIFM overlap or where the AIFM is managing an individual account<sup>165</sup>, the AIFM may end up in the situation whereby an investment decision taken by the fund manager may favour some investors over the other.<sup>166</sup> Similarly, conflicts of interest may arise where a private broker is a counterparty to an AIF the assets of which it keeps in custody or when prime brokers own AIFs at the same time clearing and executing trades for those funds charging transaction fees.<sup>167</sup> More frequent trading earns more trading commission and greater lending earns more interest on the amounts lent. Another example is found at the level of fund distribution, where distributors belong to the same financial group as the AIFM thus compromising independence of investment advice.<sup>168</sup>

In such cases, there is greater potential for conflicts of interest. Therefore, the AIFMD requires AIFMs to take all reasonable steps to identify those in advance and where possible take steps to prevent them. In the case of such an eventuality the AIFM must act in the best interest of the investors of the AIF it manages.<sup>169</sup>

The AIFMD, as further supplemented by the AIFMR, recognises that there may be conflicting interests of AIFM management and employees, investors of the same AIF or of other AIF or UCITS managed by the same AIFM and of the third parties providing other services, like prime brokers.<sup>170</sup> AIFMR specifies situations where conflicts of interest are likely to occur given the potential for a financial gain or avoidance of a financial loss.<sup>171</sup> AIFMs are required

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<sup>164</sup> Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability- related disclosures in the financial services sector, OJ L 317, 9.12.2019, pp. 1–16.

<sup>165</sup> As permitted by Article 6 of the AIFMD.

<sup>166</sup> Academic paper documents strategic cross-fund subsidization of "high family value" funds compared to lower value ones within a mutual fund family. Massa, M., Matos, P., and J. Gaspar, "Favoritism in Mutual Fund Families? Evidence on Strategic Cross-Fund Subsidization," *Journal of Finance*, February 2006, Vol 61(1), pp. 73-104.

<sup>167</sup> See for actual cases discussed in Majed R. Muhtaseb "What is the consequence of the missing compliance function at hedge funds? Fraud is! Analysis, lessons, solutions", *Journal of Investment Compliance*, 2010, Vol 11, No. 1, pp. 35 - 52.

<sup>168</sup> Isabel Lebbe, *UCI: Prevention of Conflicts of Interest, protection of Assets and Liability*, *Uniform Law Review - Revue de droit uniforme*, 2010, Vol. 15(3-4), p. 792.

<sup>169</sup> Article 14 of the AIFMD, Articles 30 - 37 of the AIFMR.

<sup>170</sup> Article 14(1) of the AIFMD

<sup>171</sup> Article 30 of the AIFMR.



to disclose potential and actual conflicts of interest to investors and to maintain appropriate policies and procedures to address such conflicts. This includes the requirement to ensure a degree of independence of specified staff so that no undue influence is exerted on their activities.<sup>172</sup>

86% of the respondents to the General Survey agreed that AIFMs should have an appropriate conflicts of interest management policy. 20% of the AIFM respondents stated that following the AIFMD adoption they have undertaken significant changes to the procedures for managing conflicts of interest while 74% reviewed their policies but did not make any significant changes.<sup>173</sup> According to the KPMG Report, the evidence supports the conclusion that the AIFMD provisions requiring disclosure of conflicts of interest increased transparency for investors, which is a foremost concern for the majority of investors in alternative assets.<sup>174</sup>

### 2.3.3 Valuation rules

A proper valuation of AIF's assets is paramount in establishing each investor's share in a given fund, particularly in the case of redemption of the fund's shares or units<sup>175</sup>, for monitoring a fund's performance and for determining thereto linked remuneration of the AIFM. The task is more challenging where for certain financial instruments there is no active market and thus no quoted prices to determine their value. In such cases various valuation techniques are used to derive a fair value of hard-to-value assets due to their complexity (like OTC derivatives<sup>176</sup>) or because they are privately held (investments in private companies<sup>177</sup>). However, regardless of the methodologies used to value AIFs' asset this process now must respect the principles laid down by the AIFMD.<sup>178</sup>

An AIFM is required to establish appropriate and consistent valuation procedures for each AIF it manages and disclose them to investors.<sup>179</sup> Regularity of asset valuation depends on the type of AIF<sup>180</sup> and on the redemption frequency but it must be performed at least once a year.<sup>181</sup> Where the valuation function is performed by an AIFM internally or by an external valuer, which is also an appointed depository for the managed AIFs, AIFMs must ensure that this is done with a requisite degree of independence of the staff (including obtaining asset prices from independent sources<sup>182</sup>) and that potential conflicts of interest are mitigated.<sup>183</sup>

Furthermore, an external valuer must possess relevant professional qualifications and, just as an internal valuer, perform asset valuation with the due skill, care and diligence.<sup>184</sup> Valuation

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<sup>172</sup> Article 33 of the AIFMR.

<sup>173</sup> KPMG Report, p. 219.

<sup>174</sup> Alts Transparency: Finding the Right Balance [<https://www.northerntrust.com/documents/campaign-landing/cis/2017/alt-transparency.pdf>].

<sup>175</sup> Collective investment undertakings redeem units or shares at the net asset value, which is the value of a fund's portfolio securities and other assets, less liabilities.

<sup>176</sup> IOSCO, Principles for the Valuation of Collective Investment Schemes, May 2013, [<https://www.iosco.org/library/pubdocs/pdf/IOSCOPD413.pdf>]

<sup>177</sup> IPEV Board, *International Private Equity and Venture Capital Valuation Guidelines*, [[www.privateequityvaluation.com/Portals/0/Documents/Guidelines/IPEV%20Valuation%20Guidelines%20-%20December%202018.pdf?ver=2018-12-21-085233-863&timestamp=1545382360113](http://www.privateequityvaluation.com/Portals/0/Documents/Guidelines/IPEV%20Valuation%20Guidelines%20-%20December%202018.pdf?ver=2018-12-21-085233-863&timestamp=1545382360113)]

<sup>178</sup> Article 19 of the AIFMD and Articles 67-74 of the AIFMR.

<sup>179</sup> Article 19 (1) and (3) of the AIFMD.

<sup>180</sup> Closed-ended vs open-ended AIFs.

<sup>181</sup> Article 19(3) of the AIFMD.

<sup>182</sup> Article 67(1) of the AIFMR.

<sup>183</sup> Article 19(4) of the AIFMD, Article 67(2)(a) and (4) of the AIFMR.

<sup>184</sup> Article 19(5) and (6) of the AIFMD.

procedure and valuations performed by AIFMs internally can be subject to an additional verification by an external valuer or an auditor.<sup>185</sup> In any event, AIFMs remain responsible for the proper valuation of assets, calculation and publication of NAV whilst being able to hold external valuers liable for any losses suffered due to their negligence or intentional failure to perform the entrusted tasks.<sup>186</sup>

According to the results of the General Survey, there is a wide agreement that the AIFMD rules concerning valuation are appropriate and have contributed to greater consistency among AIFM valuation processes<sup>187</sup> although they have not led to significant changes in the quality of asset valuation.<sup>188</sup> The figures indicate that post-AIFMD there was an increase in internal (from 21% to 31%) as well as external (from 35% to 41%) valuations.<sup>189</sup> The private equity/venture capital sector saw a shift from external to internal valuations.

A number of respondents to the General Survey questioned the allegedly binary nature of the AIFMD valuation rules suggesting that a combined use of internal and external valuations could permit specialisation of external valuers and ensure a stable supply of specialised and competitively priced services on the market.<sup>190</sup>

Moreover, some respondents drew attention to the fact that the level of liability of external valuers is determined by national law in accordance with the national interpretation of ‘negligence’.<sup>191</sup> The AIFMD concept of negligence is not elaborated making no distinction between ‘gross negligence’<sup>192</sup> and ‘simple errors’. In the former case the full redress is due and a NCA could impose a fine, whereas in the latter case of simple errors, those must be corrected. It is claimed by some respondents to the General Survey that this legal dichotomy as well as professional guarantees that need to be provided by external valuers are prompting a shift from external to internal valuation, in particular with respect to real estate, whereby external valuers only provide an input to the internal valuation process. This trend may have implications in terms of micro-prudential risks tackled by the AIFMD.<sup>193</sup>

Overall the AIFMD valuation rules brought greater discipline and structure in the AIF asset valuation process, which benefits investors.<sup>194</sup> Professional and operational requirements imposed on external valuers are deemed to have contributed to an improvement in the quality of their services and enhanced transparency for investors.<sup>195</sup>

#### **2.3.4 Depository regime**

The global financial crisis was marked by a number of events<sup>196</sup> leading to irrecoverable loss of investor assets, which laid bare the necessity to strengthen investor protection. The idea of

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<sup>185</sup> Article 19(9) of the AIFMD.

<sup>186</sup> Article 19 of the AIFMD.

<sup>187</sup> KPMG Report, pp. 182 and 185.

<sup>188</sup> *Ibid.*, p. 186.

<sup>189</sup> *Ibid.*, p. 182.

<sup>190</sup> *Ibid.*, pp. 182 and 185.

<sup>191</sup> *Ibid.*, p. 183.

<sup>192</sup> There was a view in the EGESC meeting of 27.09.2019 calling for establishing ‘gross negligence’ as the standard of responsibility for valuers under the AIFMD.

<sup>193</sup> KPMG Report, p. 183.

<sup>194</sup> *Ibid.*, pp. 183-184.

<sup>195</sup> *Ibid.*

<sup>196</sup> Collapse of Lehman Brothers Bank and uncovering of fraudulent asset management business of Bernard Madoff.

introducing a harmonised depository regime for the AIFs akin to the one contained in the UCITS framework found support among the EU decision-makers. As a result, a harmonised and robust depository regime was introduced in the AIFMD<sup>197</sup> requiring a third party, i.e. an appointed depository, to safe-keep AIFs' assets and oversee AIFs' compliance with national legislation and the AIF rules.

The AIFMD requires appointing, by means of a written contract, a single depository for each AIF managed by the AIFM.<sup>198</sup> As a general rule, the depository is required to be established in the same Member State as the AIF.<sup>199</sup> Only the entities defined in the AIFMD are eligible to assume the role of a depository<sup>200</sup> explicitly excluding the AIFMs of the concerned AIFs for the avoidance of insurmountable conflicts of interest.<sup>201</sup> This exclusion is justified given that the depository, besides asset safe-keeping, is also entrusted with a number of oversight duties, including monitoring of the AIFs' cash flows.<sup>202</sup>

The delegation of depository functions is limited to safe-keeping of assets and is only permitted under certain conditions, including holding of financial instruments in segregated financial instruments accounts along the custody chain.<sup>203</sup> The depository, however, remains liable to the AIF or to the investors of the AIF for the loss of assets by the third party, except in case of a liability discharge or if it can prove that the loss occurred due to an external event beyond the depository's reasonable control.<sup>204</sup>

The majority of respondents to the General Survey agreed that depositaries provide for an appropriate level of protection for professional investors and that oversight responsibilities of the depository cover the appropriate activities of the AIFM/AIF.<sup>205</sup> The respondents indicated that on average it costs EUR 500,000 to obtain a depository licence. This has not appeared to deter depositaries from entering the market.<sup>206</sup> At the same time, some respondents communicated their challenges in ensuring compliance with the AIFMD or called for further development of the regulatory framework.

Some respondents advocated introducing a depository passport enabling a cross-border supply of depository services.<sup>207</sup> In the same vein, several respondents provided positive feedback on the transitional provision, which expired on 22 July 2017 and according to which the relevant NCA could accept a depository being established in another Member State than the AIF.<sup>208</sup> This option was claimed to be of great importance for smaller markets where the choice of depositaries is very limited. Too few sub-custodians, difficulties in finding fund administrators (independent from the depository) and uncertainties as to how to verify ownership of venture capital investments were also mentioned as practical hurdles in ensuring compliance with the AIFMD.<sup>209</sup>

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<sup>197</sup> Leading to an upgrade of the UCITS depository regime accordingly.

<sup>198</sup> Article 21(1) and (2) of the AIFMD.

<sup>199</sup> Article 21(5) of the AIFMD.

<sup>200</sup> Article 21(3) of the AIFMD.

<sup>201</sup> Article 21(4) of the AIFMD.

<sup>202</sup> Article 21(7) and (9) of the AIFMD.

<sup>203</sup> Article 21(11) of the AIFMD.

<sup>204</sup> Article 21(12) and (13) of the AIFMD.

<sup>205</sup> KPMG Report, p. 94.

<sup>206</sup> *Ibid.*, p. 147.

<sup>207</sup> *Ibid.*, pp. 95 and 207.

<sup>208</sup> *Ibid.*, pp. 203 and 208, Member State derogation based on Article 61(5) of the AIFMD.

<sup>209</sup> *Ibid.*, p. 96.

Several respondents to the General Survey indicated challenges in relation to prime brokers. Certain views favoured imposing an obligation on the US prime brokers to report to the depository on the AIF assets.<sup>210</sup> In addition, interpretation of the provisions on delegation of custody to prime brokers was claimed to vary in different Member States.<sup>211</sup> Some respondents criticised the requirement to hold multiple omnibus accounts to ensure full compliance with the asset segregation rules. They judged the requirement laid down in Delegated Regulation 231/2013 as inefficient and burdensome. Some pointed out the differing interpretations of a Central Securities Depository's (CSD) liability in the custody chain, whereas others noted that they would have concerns if the AIFMD rules were applied to CSDs.<sup>212</sup>

In the framework of ongoing implementation work regarding the Delegated Regulation on safe-keeping duties of depositaries<sup>213</sup>, questions appeared as to the application of delegation rules to tri-party collateral managers. The tri-party collateral manager is the delegate of the depository and of the AIFM where the latter chooses to use tri-party collateral management services. The AIFMD, however, does not contain specific rules to govern such relationships.

Despite the past difficulties,<sup>214</sup> recital 36 of the AIFMD invites the European Commission to examine the possibility of putting forward an appropriate horizontal legislative proposal conferring a right to depositaries to provide services in another Member State. Gaps in harmonisation of national laws on securities and major differences in fund accounting rules continue to persist and for some are key obstacles for the EU depository passport. On the other hand, the latter do not present insurmountable hurdles to the depository passport as evidenced by the cross-border activities during the transitional period. In 2018, about 10% of the depositaries had a different domicile than the fund. Given expiration of the transitional arrangements, there seems to be a compelling reason to find a solution for the smaller markets where depository service providers are very few to choose from, if any.

As regards the feedback relating to prime brokers, it should be recalled that depositaries can only delegate safekeeping of assets. The delegation of asset safe-keeping to prime brokers is limited to delegation of custody.<sup>215</sup> The prime broker is obliged to provide a daily statement to the depository, which includes information about the value of the assets held in custody. The depository must ensure that the reporting flow is clearly stipulated in its delegation contract with the prime broker.

The recent amendments to the Commission Delegated Regulation 231/2013<sup>216</sup> allow the comingling of the depository's clients' assets at the delegate level, while requiring that the depository's own assets, the delegate's own assets and the delegate's other clients' assets are segregated. The amended Delegated Regulation clarifies that the depository itself must maintain a record in the financial instruments account it has opened in the name of the AIF or

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<sup>210</sup> This seems linked to a lack of enforcement of Article 91 of AIFMR, which contains a general obligation for prime brokers to report to the depository on the AIF assets.

<sup>211</sup> KPMG Report, p. 96.

<sup>212</sup> Ibid., pp. 96 and 113.

<sup>213</sup> Commission Delegated Regulation 2018/1618 of 12 July 2018 amending Delegated Regulation (EU) No 231/2013 as regards safe-keeping duties of depositaries, OJ L 271, 30.10.2018, p. 1.

<sup>214</sup> In the past, the Commission had brought forward twice the idea of a depository passport, first in its proposal for a UCITS II Directive, which has never been adopted, and much later in its proposal for AIFMD, which has, due to a lack of support by co-legislators, been adopted without the relevant provision.

<sup>215</sup> Article 21(4)(b) of the AIFMD.

<sup>216</sup> Commission Delegated Regulation 2018/1618 of 12 July 2018 amending Delegated Regulation (EU) No 231/2013 as regards safe-keeping duties of depositaries, OJ L 271, 30.10.2018, p. 1.

in the name of the AIFM on behalf of the AIF and, therefore, cannot exclusively rely on the books and records held by the delegate.<sup>217</sup>

As regards the application of the AIFMD rules to CSDs, one of the guiding principles of the Union is to preserve a level playing field. This means that entities providing the same services should be subject to the same rules, except where it is imperative to account for the relevant differences. Treating a CSD as a delegate of a depository is also of practical importance. Given that depositories are subject to strict liability where delegates lose AIFs' assets they should be able to fulfil their duties and to undertake due diligence measures when assets are in the CSD's custody.

Overall, the AIFMD regime for depositories is judged to remain relevant, effective and efficient. Rules governing delegation of custody to third parties have been clarified by the mentioned amendments to the Delegated Regulation addressing the alleged shortcomings. A number of the other discussed issues could be addressed by considering changes to the AIFMD.

## **2.4 AIFMD impact on financial stability**

As AIFs become a larger part of the financial system, monitoring and managing systemic risks in the sector becomes more important.<sup>218</sup> Total assets, leverage multipliers and liquidity mismatches differ significantly across different fund types but also within the AIF sector. The ESRB has recently issued Recommendation ESRB/2017/6 to address financial stability concerns relating to investment funds with an annex listing four major sources of systemic risk in the investment funds sector.

The first concern is that a market shock may give rise to increased redemption demand, which in turn gives rise to an increased sale pressure in an already falling market. Mismatches between the liquidity of open-ended investment funds' assets and their redemption profiles could lead to "fire sales" to meet redemption requests in times of market stress, potentially affecting other financial market participants holding the same or correlated assets.

Second, the incentive to generate greater yields through greater leverage and illiquidity may lead to the sector as a whole becoming less resilient to market stress. Leverage does not only amplify returns in upswings but also amplifies the potential losses from negative market movements and may result in funds amplifying the financial cycle. The continued growth of the AIF sector, combined with an increase in its liquidity transformation activity, could give rise to increased financial stability risks.

Third, the "first mover advantage" in open-ended funds implies that redemption demands may indeed materialise more quickly than expected and reputational concerns may make fund managers reluctant to suspend redemptions.

Fourth, increased reliance on electronic trading, the fragmentation of the sources of liquidity, and smaller holdings of assets by traditional market makers such as banks and broker-dealers, as well as external factors such as monetary policy all suggest that the structure of liquidity provision can change over time and hence hamper liquidity provision in times of stress.

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<sup>217</sup> Ibid., Recital 4.

<sup>218</sup> Cf. Section 2.1.1.

To address those issues the AIFMD permits NCAs to impose leverage limits on an AIFM or other restrictions to limit the extent to which the use of leverage contributes to the build-up of systemic risk in the financial system.<sup>219</sup> NCAs can also suspend redemptions in the interest of the public.<sup>220</sup> Furthermore, regular supervisory reporting obligations imposed by the AIFMD enable NCAs to assess trends in the AIF industry and to monitor threats to financial stability considering the markets in which AIFs are trading.<sup>221</sup> The reported data can be put to use not only at national level but also at supra-national level. According to IOSCO, “*the AIFMD provides a common framework for the macroprudential oversight of the sector allowing coordinated actions as necessary to ensure the proper functioning of financial markets*”.<sup>222</sup>

The supervisory reporting requirements as well as the AIFMD rules on risk and liquidity management are relevant for AIFMs active in extending credit to borrowers. The AIFMD, however, does not specifically regulate loan-originating AIFs. Instead, there are differing national rules binding AIFs that provide non-bank finance. These rules comprise requirements regarding the fund structure, leverage limits and maturity lock-ups.<sup>223</sup> As credit booms increase risks to financial stability<sup>224</sup>, it may be worthwhile considering an EU-wide approach to AIFs issuing loans.<sup>225</sup> ESMA’s opinion, which emphasises the benefits of ensuring a level playing field for stakeholders and supporting the development of a non-bank lending sector, represents useful input.<sup>226</sup>

#### *a) Supervisory reporting requirements*

There was a clear need to devise an effective mechanism to share, pool and analyse information at the European level enabling to effectively monitor the AIF market and the aggregate risk transmission channels in the broader financial system. Consequently, AIFMs, regardless of their place of establishment, were subject to the reporting obligations in accordance with the AIFMD, as further supplemented by more detailed requirements.

The AIFMD imposes supervisory reporting obligations on the AIFMs as opposed to their managed AIFs. The recipients of the information are NCAs. Once the data is reported, the NCA of the home Member State of the AIFM must ensure that it is made available to the NCAs of other relevant Member States, ESMA and the ESRB.<sup>227</sup>

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<sup>219</sup> Article 25 of the AIFMD.

<sup>220</sup> Article 46 of the AIFMD.

<sup>221</sup> In addition to the Directive itself, other legal sources for AIFMD reporting include Commission Delegated Regulation (EU) No. 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (AIFMR); Guidelines prepared by the European Securities and Markets Authority (ESMA) on reporting obligations under Articles 3(3)(d) and 24(1), (2) and (4).

<sup>222</sup> IOSCO Final Report on Liquidity Management Tools in Collective Investment Schemes: Results from an IOSCO Committee 5 survey to members of December 2015, FR 28/2015. Retrieved from: <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD517.pdf>.

<sup>223</sup> Non-bank Lending in the European Union, Alternative Credit Council/Allen & Overy, 2019.

<sup>224</sup> Moritz Schularick, Alan M Taylor, *Credit Booms Gone Bust: Monetary Policy, Leverage Cycle and Financial Crisis, 1870-2008*, American Economic Review, 102, pp. 1029-1061.

<sup>225</sup> As also suggested by some Member States in the EGESC meeting of 27.09.2019.

<sup>226</sup> ESMA Opinion, Key principles for a European framework on loan origination by funds, ESMA/2016/596, 11.04.2016.

<sup>227</sup> Point (3) of Article 25 of the AIFMD.

The AIFMD reporting framework consists of 69 reporting obligations, which equates to a total of 517 data points to be reported.<sup>228</sup> The legal reporting obligations for registered and authorised AIFMs cover the main instruments in which their managed AIFs are trading, principle exposures and the most important investment concentrations of the AIFs.<sup>229</sup> A full-scope AIFM must moreover report a breakdown of its investment strategies, the concentration of investors and the principal markets in which the respective AIFs trade as well as risk profiles of individual AIFs, including market risk, counterparty risk, liquidity and operational risk profiles, stress test results and other risk aspects such as the leverage values of the AIFs.<sup>230</sup>

The results of the General Survey and evidence-based study indicate problems concerning data coverage. Some respondents doubted that all the submitted data is relevant, while others, mostly NCAs, thought reported data may be insufficient.<sup>231</sup> Interviewed NCAs stated that they would like to receive more information on liquidity and leverage, for example, results of liquidity stress tests carried on the basis of common methodology, taking into account capital requirements and more data on leverage.<sup>232</sup> Data relating to loan origination was mentioned as desirable by some NCAs.<sup>233</sup> ESMA opined that reporting information on the Value at Risk (VaR) of AIFs should be particularly relevant for HF.<sup>234</sup> It further suggests complementing current reporting to NCAs with the information concerning:

- ‘the portfolio’s sensitivity to a change in foreign exchange rates or commodity prices; the total number of transactions carried out using a high frequency algorithmic trading technique, as defined in MiFID II, together with the corresponding market value of buys and sells in the base currency of the AIF over the reporting period;
- the geographical focus expressed as a percentage of the total value of AuM, so “that the impact of financial derivative instruments is better taken into account”; and
- the extent of hedging through long/short positions by an AIFM/AIF expressed as a percentage;<sup>235</sup>
- data on non-EU master AIFs that are not marketed into the EU, but which have an EU feeder AIF or a non-EU feeder marketed into the EU if managed by the same AIFM.<sup>236</sup>

In fact, the Financial Stability Board (FSB) observes that the markets for leveraged loans and collateralised loan obligations (CLOs) have grown significantly in the US and to a lesser extent in the EU in recent years.<sup>237</sup> According to its analysis, in 2014 the issuance of CLO exceeded pre-crisis levels and continues to grow.<sup>238</sup> According to the supervisory and market

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<sup>228</sup> Fitness Check Report FC: SWD(2019) 403 final. The number of reporting obligations and data points are based on analysis provided by an external contractor BRAG.

<sup>229</sup> Article 3(3)(d) and Article 24(1) of the AIFMD.

<sup>230</sup> Point (2) of Article 24 of the AIFMD.

<sup>231</sup> KPMG Report, p. 155.

<sup>232</sup> Ibid.

<sup>233</sup> Ibid., p. 83.

<sup>234</sup> Ibid., p. 155.

<sup>235</sup> Ibid.

<sup>236</sup> Ibid., pp. 155-156.

<sup>237</sup> The role of non-bank financial institutions in the leveraged loan and CLO markets has increased. See Financial Stability Board, *Vulnerabilities associated with leveraged loans and collateralised loan obligations (CLOs)*, PLEN/2019/91-REV, 22 November 2019.

<sup>238</sup> Ibid.

data analysed by the FSB, while banks and insurance companies have the largest direct exposures to leveraged loans and CLOs, some open-ended investment funds hold such instruments and their liquidity could be affected in times of stress. The information on indirect linkages between banks and non-banks is missing making it difficult to appraise systemic implications of the existing interconnectedness.<sup>239</sup> FSB suggests that data gaps should be closed by collecting the necessary information in relation to leveraged loans and CLO.

In addition, there were suggestions to make the use of a legal entity identifier (LEI) for AIF or AIFMs mandatory.<sup>240</sup> This would permit better matching and merging of the AIFMR data with the data reported under European Market Infrastructure Regulation (EMIR), Securities Financing Transactions Regulation (SFTR) or other Union legislation and leading to better data analysis.

The respondents to the General Survey also mentioned the overlapping reporting obligations under other pieces of EU legislation as an issue. Indeed, the results of the Fitness Check of EU Supervisory Reporting Requirements<sup>241</sup> confirmed overlaps of the AIFMD with reporting under the Money Market Fund Regulation (MMFR) as well as with the ECB's collecting of the investment funds data for the statistical purposes. Some respondents called for harmonising the AIFMD reporting requirements with those under the EMIR, SII, CRR and other pieces of Union legislation, and at international level.<sup>242</sup>

Furthermore, results of the General Survey point to an inconsistent understanding of what must be reported. This concern was voiced both by the NCAs and the industry. Despite the fact that key reporting obligations are laid down at EU level and ESMA has issued Guidelines driving further convergence among the national reporting systems<sup>243</sup>, it remains within the national discretion to stipulate the method of data delivery and the provision of additional information on a periodic or an ad hoc basis. This leads to differences in the national interpretation and filing procedures, which were considered by the respondents as increasing costs of reporting even further.

The lack of a uniform approach at national level was also recognised during the Fitness Check. It is noted that several Member States impose additional reporting obligations at national level that are more granular than those foreseen under the AIFMD (this includes metrics concerning the funds' portfolio composition in terms of financial instrument, geographical focus, investment strategy or risk profile of the fund as a whole).

The Fitness Check also revealed that a number of supervisors consider the definitions for individual fields are too broad leaving too much discretion to AIFMs in terms of underlying methodology and assumptions. This also results in limited consistency across the same fields reported by AIFMs. Concrete examples include concepts such as 'AuM' and 'reported gross/commitment leverage calculations'.

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<sup>239</sup> Ibid. Also *see supra* 9 ESRB recommendation.

<sup>240</sup> KPMG Report, p. 84. *See supra* 9 ESRB recommendation.

<sup>241</sup> Commission Staff Working Document Fitness Check of EU Supervisory Reporting Requirements, SWD(2019) 402 final, 6.11.2019.

<sup>242</sup> KPMG Report, p. 86.

<sup>243</sup> ESMA Guidelines on reporting obligations under Articles 3(3)(d) and 24(1), (2) and (4) of 8.08.2014 ESMA/2014/869E.



The KPMG study also identified concerns regarding the “one size fits all” approach to supervisory reporting claiming that it fails to fully reflect the different nature of the underlying funds. It has also questioned whether the proportionality principle is respected when small firms engaged in less risky strategies are subject to detailed reporting requirements.<sup>244</sup> Similarly, in the context of the Fitness Check, some stakeholders complained that the current reporting framework is not adequately tailored considering the differences in the operations and associated risks of different AIFs. Suggesting that not all reporting fields are always relevant (e.g. market risk indicators, stress tests) a proposal was made to refocus the requirements to tailor them to each investment strategy.

The respondents to the General Survey agree that the initial investment in implementing the necessary internal structures to fulfil reporting obligations was substantial and any changes proposed should be assessed being conscious of the significant sunk costs. Given the results of the KPMG study and the Fitness Check, it is apparent that further improvements to the reporting framework under the AIFMD are possible.

Finally, bottlenecks exist for ESMA to receive all the reporting data from NCAs even though improvements in this respect are continuous.<sup>245</sup> At the same time, the respondents to the General Survey indicated that they would appreciate information on how the collected data is used.<sup>246</sup> Whilst the regular reports on the national AIF/AIFM markets remain scarce, 60% of the respondent NCAs confirmed they produce regular analysis to monitor market trends.<sup>247</sup> Moreover, the accumulated databases allow identifying and interrogating outliers.<sup>248</sup> In 2017 ESMA published the first statistical report on the EU AIF market and aims to issue one every year. Increased publicity of conclusion drawn up by supervisors based on the collected data would also leave the markets better informed.<sup>249</sup>

The AIFMD introduced for the first time an EU-wide approach to supervisory reporting in the context of AIFs. Despite the fact that the reporting obligation proved successful by providing the NCAs with the significant volumes of data to monitor systemic risks, certain areas were identified as requiring further clarification and cooperation among the supervisory authorities. Member States were also broadly in agreement that the AIFMD reporting obligations should be streamlined.<sup>250</sup>

The relevant discussion in international fora will influence this area. The following section refers to the IOSCO work on leverage calculation. IOSCO proposes jurisdictions to collect national/regional aggregated GNE or GNE adjusted data, broken down by asset class and long and short exposures, as well as NAV, on a yearly basis, as a solution to monitor leverage trends overtime.<sup>251, 252</sup> The focus on the format of the reported data is likely to influence the current reporting template of the AIFMR.

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<sup>244</sup> Supra 108, pp. 413 - 414.

<sup>245</sup> KPMG Report, pp. 156 and 157.

<sup>246</sup> Ibid., p 85.

<sup>247</sup> Ibid.

<sup>248</sup> Ibid.

<sup>249</sup> Ibid., p. 156.

<sup>250</sup> EGESC meeting of 27.09.2019.

<sup>251</sup> IOSCO recommends regulators to collect GNE or adjusted GNE broken down by asset classes, and long and short exposures. Gross Notional Exposure (GNE), which is the sum of all the absolute value of all positions / NAV, is very similar to the "gross method" under the AIFMR. GNE adjusted, which implies adjusting GNE with regards to some derivative positions (e.g. adjustment of interest rate derivatives positions by 10-year bond duration), is very similar to the methodology used for private funds in the US.

There are views that the AIFMD supervisory reporting data should be reported centrally, for example to ESMA, which would validate it and store it in a fashion similar to its handling of the daily transactions reporting data under MiFID II. The authorised entities then could access the central database in accordance with their mandates. This could reduce administrative costs for the NCAs and industry alike and ensure that authorities with financial stability mandates access all the relevant data.

Moreover, it may be worthwhile considering whether for macro-prudential reasons it may be more useful for the supervisors to receive a full portfolio holdings of the AIFs or at least with respect to a particular asset class, such as for example CLO or leveraged loans, in order to get a better overview of the market. In the meantime, ESMA is continuing to provide technical clarifications on the supervisory reporting requirements in order to achieve greater uniformity across the Union.<sup>253</sup>

#### *b) Leverage calculation methodologies under AIFMR*

Leverage is considered one of the key risks and vulnerabilities related to asset management activities.<sup>254</sup> It is used as a technique, often through the use of derivatives, to increase returns through borrowing of assets, including cash or securities. Excessive use of leverage, however, amplifies potential losses in case of negative shocks, thereby reducing the resilience of market participants.

The AIFMD provisions on the monitoring of systemic risks<sup>255</sup> include the calculation of leverage and the reporting of the leverage levels to the NCAs. Leverage-related data are monitored and shared among the national regulators and ESMA.<sup>256</sup> More specifically, the AIFMR requires leverage to be calculated in accordance with two methods: (i) ‘the gross method’, which is the sum of the absolute values of all positions, so as to give an indication of overall exposure and (ii) ‘the commitment method’, which is the sum of the absolute values of all positions, adjusted for various factors, including the application of netting and hedging arrangements.<sup>257</sup>

A representative majority of the asset management industry and the NCAs regard the leverage provisions under the AIFMD as appropriate and effective.<sup>258</sup> Moreover, the methodologies under the AIFMR are deemed to be comprehensive and advanced in comparison to the other existing measures of leverage thereby encouraging harmonization towards these methodologies at global level.<sup>259</sup>

The combination of gross and commitment methods to measure leverage under the AIFMR, albeit initially criticised as being too burdensome, provides a clear leverage exposure at the level of an individual AIF. There are different challenges in calculating leverage across a wide

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<sup>252</sup> The data collection will likely be conducted by IOSCO in a phased-in manner as it will take one to four years for some jurisdictions to make legislative changes to collect the relevant data.

<sup>253</sup> ESMA Work stream on the data reporting.

<sup>254</sup> FSB Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities, 12 January 2017; IOSCO Final Report on Recommendations for Liquidity Risk Management for Collective Investment Schemes of February 2018, FR01/2018.

<sup>255</sup> Recital 3 of the AIFMD.

<sup>256</sup> Article 25 of the AIFMD.

<sup>257</sup> Section 2 of Chapter II of the AIFMR.

<sup>258</sup> KPMG Report, pp. 171-172.

<sup>259</sup> Ibid., p. 171.

range of portfolios with different investment strategies and different risks in relation to their underlying assets. No unique single measure can capture all the risks and give a representation of the potential economic over-exposure of investment funds and every measure of leverage has some drawbacks. This is also true for the AIFMR methodologies.

Admittedly, there are limitations in the AIFMR commitment approach linked to the complexity of its netting rules, which can imply a certain lack of clarity and a certain degree of subjectivity on the measuring of hedges or offsetting positions. There are opinions that the prescribed methods do not align with industry practice in some sectors (closed-ended funds, private equity funds) and lack the necessary metrics to provide accurate reflection of the risks associated with the use of leverage. Nevertheless, the leverage calculation methods set forth by the AIFMR are considered sufficiently sophisticated. Any changes thereto should improve comparability of data reported and leverage calculations. Necessarily this would require taking into account developments at international level, notably the IOSCO policy work regarding measures of leverage in investment funds.<sup>260</sup>

Considering the difficulties in coming up with a “consistent” measure of leverage that could be aggregated across funds and jurisdictions<sup>261</sup>, IOSCO recommends adopting a leverage framework based on a two-step approach. As a step 1, based on a gross measure of leverage, one would filter and identify those funds that may pose risks for financial stability and deserve further risk analysis.<sup>262</sup> In step 2, a list of indicators and complementary risk-based measures are provided by IOSCO for NCAs consideration to assess potential risks posed by funds identified under step 1. This would leave each jurisdiction free to fine-tune the reporting requirements and risk-based leverage methodologies further depending on the size and complexity of their markets.

### *c) Risk and liquidity management rules*

Effective management of risks stemming from the AIFs investments benefits not only fund investors by potentially maximising risk-return ratio and by securing redemptions in line with the AIF’s policy but also has a positive effect on stability of the financial system.<sup>263</sup> The EU legislature considered that these objectives could be better served if the risk management function of the AIFM were independent from the portfolio management (which is also in line with the standards applicable to other financial intermediaries regulated by other Union laws<sup>264</sup>).

According to the AIFMD, in the organisational structure of the AIFM a permanent risk management function must be functionally and hierarchically separate from the operating units, including portfolio management function.<sup>265</sup> Staff managing AIF’s risk exposures should enjoy a degree of independence and authority in fulfilling their role in shaping the risk policy of the AIF and monitoring compliance with the AIF’s risk profile.<sup>266</sup> Remuneration

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<sup>260</sup> Seconded by Member States at the EGESC meeting of 27.09.2019.

<sup>261</sup> Due to the differences in reporting requirements across jurisdictions, market structures, funds’ strategies.

<sup>262</sup> IOSCO proposes to use metrics based on gross exposure under step 1: Gross Notional Exposure without adjustments or the Gross Notional Exposure adjusted for interest rate derivatives and options. IOSCO indicates that jurisdiction can use an additional/complementary measure to GNE or GNE adjusted by taking into account potential netting and hedging arrangements or relationships in the fund’s gross exposure.

<sup>263</sup> Depending on the risk appetite of an investor.

<sup>264</sup> Article 12(2) UCITS Level 2 (2010/43/EU) and Article 16(5) MiFID II. Recital 51 of AIFMR. Also *see* Dirk Zetzsche, pp. 81, 348 and 357.

<sup>265</sup> Article 15 of the AIFMD, Articles 39 and 42 of the AIFMR.

<sup>266</sup> Recital 51 of the AIFMR.

policy therefore must be adapted to compensate staff, who manages AIFs' risks, according to their achievements in this respect.<sup>267</sup>

More specifically, each AIF's risk profile should be defined, acceptable risk limits set, identified risks measured and monitored.<sup>268</sup> Quantitative and qualitative limits must be established for market, credit, liquidity and counterparty risks and any other risks besides those mentioned should be covered by the risk management policy.<sup>269</sup> AIFMs must conduct periodically, in any event at least once a year, stress testing to assess market risks and liquidity risks under normal and exceptional liquidity conditions.<sup>270</sup> To promote supervisory convergence in this area ESMA has recently published Guidelines on liquidity stress testing in UCITS and AIFs.<sup>271</sup>

AIFMs must also set the maximum level of leverage that can be employed on behalf of an each AIF they manage.<sup>272</sup> Furthermore, where AIFMs manage AIFs, which are not unleveraged closed-ended funds, AIFMs must have systems and procedures in place for monitoring and managing liquidity risk.<sup>273</sup> In this respect investment strategy, liquidity profile and redemption policy of the AIF should be consistent.<sup>274</sup>

Almost all of AIFM respondents to the General Survey agreed that AIFMs must have appropriate risk management policies and procedures in place.<sup>275</sup> There was broad agreement that functional and hierarchical separation of the risk management function sets a robust framework and corresponds to heterogeneous universe of AIFs.<sup>276</sup> A bit less than a half of the respondent AIFMs changed their risk management policies and 20% their liquidity management policies since the AIFMD's coming into force.<sup>277</sup>

For some AIFMs, in particular managing real estate or private equity funds, new requirements meant major changes in their *modus operandi*, as they have traditionally performed risk management as a part of the portfolio management function.<sup>278</sup> Whilst hedge fund managers found requiring separation between risk management and portfolio management to be sensible, private equity managers took the opposite view as regards their sector and referred to the increased costs.<sup>279</sup> Moreover, the latter stakeholders did not consider liquidity management requirements to be necessary for them.<sup>280</sup>

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<sup>267</sup> Article 42(1)(c) of the AIFMR.

<sup>268</sup> Articles 38 and 44 of the AIFMR.

<sup>269</sup> Articles 40 and 44 the AIFMR.

<sup>270</sup> Article 15(3)(b) AIFMD. Articles 45(3)(c) and 48 AIFMR.

<sup>271</sup> ESMA Guidelines on liquidity stress testing in UCITS and AIFs. 2.09.2019, ESMA34-39-882.

<sup>272</sup> Article 15(4) of the AIFMD.

<sup>273</sup> Article 16 of the AIFMD. Article 47 of the AIFMR.

<sup>274</sup> Article 16(2) of the AIFMD.

<sup>275</sup> KPMG Report, p. 89.

<sup>276</sup> Ibid., p. 195.

<sup>277</sup> Ibid., p. 90.

<sup>278</sup> Kai Braun and Désirée Springmann, *Risk management under the AIFMD*, 2013 December, [<https://www.ipe.com/investment/briefing-investment/risk-management-under-the-aifmd/www.ipe.com/investment/briefing-investment/risk-management-under-the-aifmd/10000541.fullarticle>]; *Risk Management for Private Equity AIFMD and SIF law – A new challenge*, PWC, [<https://www.pwc.lu/en/risk-management/docs/pwc-risk-management-for-pe.pdf>].

<sup>279</sup> KPMG Report, p. 198.

<sup>280</sup> Ibid., p. 90.

Some in the industry<sup>281</sup> opined that a uniform/harmonised set of liquidity tools should be available in all the Member States. There was a view that smaller fund managers may lack resources, in particular at the early stages of business, to implement hierarchical and functional separation of the mentioned responsibilities.

Analysis indicates that risk and liquidity management rules laid down in the AIFMD for monitoring micro-prudential risks are perceived as necessary and they are judged to be effective.<sup>282</sup> There is testimony that implementing liquidity risk management requirements helped the industry to weather several significant market dislocations.<sup>283</sup> As regards the smaller AIFMs, in particular those at the early stages of their activities, one must recall that the risk management provisions of the AIFMD do not apply until the AuM reach the set thresholds, which are judged to be appropriate.

There was evidence adduced to support a special treatment of particular sectors in the AIF universe in terms of risk management. The AIFMD rules accommodate various investment strategies, which always carry some risks. Those risks must be understood and well managed devoid of conflicts of interest. The AIFMD does not require to implement liquidity management processes for AIFs, which are unleveraged and closed-ended. Liquidity risk facing leveraged and opened ended funds, however, should be monitored and managed appropriately.

As regards the availability of liquidity tools in a harmonised way across the internal market, this has been also recommended by the ESRB<sup>284</sup> as well as the FSB<sup>285</sup> and some in the industry.<sup>286</sup> The ESRB observes that the availability of liquidity management tools varies substantially across Member States, whereas it contends that ‘the continued growth of the investment fund sector, combined with an increase in its liquidity transformation activity, could lead to increased financial stability risks that need to be addressed.’<sup>287</sup>

The ESRB recommends the Commission (i) to consider including additional liquidity management tools in the constitutional documents or other pre-contractual information of AIFs (as a minimum the power to suspend redemptions should be included), (ii) provide investors with sufficient transparency in relation to such tools, (iii) ensure that the necessary operational capacity and contingency planning is available for the timely activation of such additional liquidity management tools, and (iv) report to the NCAs on the implementation and use of such additional liquidity management tools in stressed market circumstances. Most of the Member States accept the use of various liquidity management tools.

While liquidity management tools remain primarily the responsibility of the fund manager, the ESRB highlights that there could be situations in which fund managers may be reluctant to suspend redemptions to avoid reputational costs and competitive disadvantages. There could also be situations where a lack of clearly assigned responsibilities for NCAs might lead

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<sup>281</sup> AMIC and EFAMA.

<sup>282</sup> KPMG Report, p. 196.

<sup>283</sup> Ibid., p. 197, AMIC/EFAMA, *Managing fund liquidity risk in Europe –an AMIC/EFAMA report*, April 2016, p. 5.

<sup>284</sup> Supra 9.

<sup>285</sup> Supra 259, The FSB, in its final recommendations, has also encouraged authorities to review their frameworks and consider broadening the range of additional liquidity tools available to managers.

<sup>286</sup> Responses to the ESMA public consultation on the draft Guidelines on liquidity stress testing in UCITS and AIFs.

<sup>287</sup> Supra 9, Annex II, C 151/17.

to insufficient reactions during stressed market conditions. The ESRB specifically recommends that the Commission proposes changes to the Union legislation to clarify the NCAs' respective roles and cooperation between them when using their powers to suspend redemptions in situations where there are cross-border financial stability implications.<sup>288</sup>

The ESRB also recommends that the European Commission should oblige NCAs to notify other relevant NCAs, ESMA and the ESRB thereof, prior to the exercise of the mentioned powers. Furthermore, the ESRB recommends setting out ESMA's general facilitation, advisory and coordination role in relation to the NCAs' powers to suspend redemptions in such situations, which could facilitate a more harmonised approach. The ESRB explains that there could be situations where fund managers face incentives not to suspend redemptions for reputational cost and competitive pressure and situations where a lack of clearly assigned possibilities for NCAs might lead to insufficient reactions during stressed market conditions. Meanwhile, a more active involvement of the NCAs risks creating moral hazard behaviour by the fund managers. Therefore, full implications thereof should be carefully considered.

The ESRB is also concerned that excessive liquidity mismatches in open-ended AIFs, could contribute to the build-up of systemic risks, as the forced sale of even a small amount of less liquid assets may rapidly lead to substantial amplifications of market falls. Therefore, the ESRB recommends the European Commission to mandate ESMA to prepare and update, based on ESMA's own analysis, a list of inherently less liquid assets. As far as investment in less liquid assets by open-ended AIFs is concerned, the crucial issue is whether the portfolio composition matches the AIF's redemption policy. In this respect, the AIFMD already requires AIFs to have redemption policies that are consistent with the liquidity profile of their investment strategy and to conduct regular stress tests under both normal and exceptional liquidity conditions.

Finally, empirical work is also necessary to determine when liquidity mismatches may be excessive. The liquidity of an asset depends on several factors (asset specific as well as market and more macroeconomic factors) and these factors can change their impact on the liquidity of an asset over time.

As regards already executed actions, recently ESMA has issued guidelines on liquidity stress testing in investment funds that brings further convergence and clarity in this area.<sup>289</sup> As a result, if there was a harmonised set of liquidity risk management tools available across the EU, AIFMs would be able to incorporate any of them in their AIFs' redemption policies. The ESRB recommends to require that AIFMs of open-ended AIFs disclose internal limits, if used, to the NCAs and to report any changes to them whenever changes are applied to them and also to disclose them to investors according to guidance to be developed by ESMA.

Finally, the relevance of an appropriate liquidity management by AIFMs is also confirmed by the FSB and IOSCO work.<sup>290, 291</sup> Further empirical work could be done to determine when liquidity mismatches are excessive and may lead to financial stability concerns and therefore warrant additional rules.

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<sup>288</sup> As provided in Article 46 of the AIFMD.

<sup>289</sup> Supra 271. These guidelines on liquidity stress testing in investment funds (UCITS and AIFs) implement one of the ESRB's recommendations calling for greater convergence across the EU on how NCA supervise the use of this liquidity management tool.

<sup>290</sup> Supra 222.

<sup>291</sup> EGESC came strongly in support of taking IOSCO work into account.

## 2.5 AIFMD impact on private (non-listed) companies

Following the European Commission's Proposal for the AIFMD, the European Parliament advocated, among other things, introducing EU rules regulating private equity industry. Specifically, calls were made to require AIFMs to disclose ownership structures<sup>292</sup>, as well as to prohibit AIFMs of private equity funds to engage in 'asset stripping'<sup>293</sup>. Following the co-decision procedure, the EU co-legislators adopted specific rules for private equity fund managers pertaining to the acquisition of controlling stakes in non-listed companies, transparency and to exercising control of AIFMs over the investee companies. The EU co-legislators have explicitly mandated the European Commission to examine the need for amending the information and disclosure requirements applicable in cases of control over non-listed companies or issuers set out in the AIFMD on a general level, regardless of the type of investor.<sup>294</sup>

### 2.5.1 Acquiring controlling stakes in private (non-listed) companies

The AIFMD seeks to provide for greater accountability of AIFMs holding controlling stakes in private (non-listed) companies through increased transparency requirements.<sup>295</sup> It was reasoned that well-functioning financial markets require transparency towards supervisors and investors.<sup>296</sup>

Pursuant to the AIFMD, AIFMs managing AIFs that acquire "control" of EU companies have to make certain disclosures to the company, its shareholders and the AIFM's competent authority.<sup>297</sup> An AIFM must inform the NCA when the share of the voting rights in the acquired private company changes from the 10%, 20%, 30%, 50% and 75% thresholds. In addition, the AIFM managing the relevant AIF must request and use its best efforts to ensure that the board of directors of the non-listed company makes available this information to the employees' representatives or, where there are none, the employees of the non-listed company.

Specifically, the AIFMs will have to provide the competent authorities and the AIF's investors with information on the financing of the acquisition. AIFMs also have to provide, either in the annual report of the relevant AIF or that of the portfolio company, a "fair review of the development of the company's business", recent "important events", and likely "future developments" regarding the company and share buybacks. This information must also be made available to the employees' representatives or, where there are none, to the employees of the non-listed company.<sup>298</sup>

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<sup>292</sup> European Parliament Resolution of 23 September 2008 with recommendations to the Commission on hedge funds and private equity (2007/2238(INI); Report of 9 July 2008 with recommendations to the Commission on transparency of institutional investors (2007/2239(INI).

<sup>293</sup> Report of 9 July 2008 with recommendations to the Commission on transparency of institutional investors (2007/2239(INI).

<sup>294</sup> Recital 55 of the AIFMD.

<sup>295</sup> IOSCO, Report on the Second Hedge Funds Survey, October 2013, p. 9.

<sup>296</sup> European Parliament Resolution of 23 September 2008 with recommendations to the Commission on hedge funds and private equity (2007/2238(INI); Report of 9 July 2008 with recommendations to the Commission on transparency of institutional investors (2007/2239(INI).

<sup>297</sup> Articles 27(2), (3), 28(1), (2) and (4) of the AIFMD. There are certain carve-outs from these obligations. Notably, pursuant to Article 26 (2) of the AIFMD, obligations for AIFMs managing AIFs that acquire control of non-listed companies do not apply where the companies concerned are special purpose vehicles with the purpose of purchasing, holding or administering real estate, or small and medium-sized enterprises.

<sup>298</sup> Article 28 of the AIFMD.

As regards the acquisition of controlling stakes in non-listed entities, only a small proportion, i.e. 12% of respondents investing in non-listed entities had also acquired control of non-listed entities, and did not fall within the Article 26 exemptions. The majority of respondents did not find the AIFMD notification requirements to NCAs to be useful, essential or burdensome.<sup>299</sup> One NCA questioned the value added of the notifications and what follow-up was expected from the supervisors at the same time noting a significant administrative cost for handling inflows of information.<sup>300</sup> The respondents also did not agree that the AIFMD has improved information provided by the AIF/AIFM to controlled companies, or that it has had a positive impact on the relationship between AIFs/AIFMs and target or investee enterprises.<sup>301</sup>

The KPMG study has not identified or presented convincing evidence of problems resulting from different interpretations. On the contrary, the feedback by the respondents appears to suggest that the AIFMD requirements and the national laws transposing the rules on acquisition of control in private companies, in conjunction with the national corporate and company law provisions, have functioned relatively well and avoided distortions in capital allocation decisions.

Given the absence of prevailing evidence of adverse effects of AIFMD rules on the acquisition of private companies or misallocation of capital or undue administrative burdens, it may be concluded that such rules are neither overly burdensome, nor provide a specific value-add. In the light of the underlying economic rationale (avoiding negative externalities), social perspective (proper allocation of resources) and regulatory needs (addressing the lack of transparency towards the competent authorities, towards the shareholders of the portfolio company and towards the employees), the AIFMD rules should be deemed as having achieved the effect of protecting non-listed companies and issuers. However, there may possibly be a need for rethinking the design of this regime aiming to attain the mentioned objectives more efficiently.

### **2.5.2 “Asset stripping” of non-listed companies**

The AIFMD contains rules to protect the non-listed companies or issuers in case of the acquisition, jointly or individually, of control against any distributions, capital reductions, share redemptions and/or acquisition of own shares by the company, i.e. against so-called “asset stripping”. The initial provisions targeting primarily private equity and venture capital investment were introduced in the context of the crucial role played by the latter in restructuring and financing companies in the EU. While uncontroversial when a company is seen as failing beyond rescue, the role of AIFs has been criticised when apparently healthy companies are targeted with investors being accused of destroying a viable business for a fast profit. The practice was seen as particularly problematic in the aftermath of the global financial crisis when the realisable value of certain companies’ assets exceeded the value of the company as a whole, thus making them valuable targets for certain AIFs.

As regards the applicable regulatory requirements, AIFMD requires that when an AIF acquires control of a non-listed EU company or an issuer, the AIFM managing such an AIF should, for a period of 24 months following the acquisition of control of the company, not be

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<sup>299</sup> It was observed by one interviewee that AIFMD’s additional requirements for investment in non-listed entities create unnecessary burdens and impediments for the sector, in contrast to the aims of CMU and the various attempts to assist small enterprises in securing capital investment. *See* KPMG Report, p. 100.

<sup>300</sup> A bilateral meeting with an NCA on 25.10.2019, DG FISMA premises.

<sup>301</sup> KPMG Report, pp. 98-99.



allowed to facilitate, vote in favour of, support or instruct any distribution<sup>302</sup>, capital reduction<sup>303</sup>, share redemption and/or acquisition of own shares by the company and in any event use its best efforts to prevent this from happening.<sup>304</sup> “Asset-stripping” related obligations have a broad scope and generally relate to a range of distributions.<sup>305</sup>

The respondents’ views on the anti-asset stripping provisions were diverse, although it should be noted that 34% of the AIFMs expressed no opinion on the applicable requirements. Out of all respondents only 14% expressed concerns about the asset stripping rules. In the view of those respondents, any deviation from a unified capital market defeats the purpose of strict harmonisation and a level playing field, which are required to create an EU-wide capital market that is not detrimental to multi-jurisdictional funds<sup>306</sup>. Furthermore, about 35% of respondent AIFMs expressed no opinion on whether the anti-asset stripping rules provide an appropriate level of protection, and the remaining 65% were equally distributed between agreement, disagreement or neutral.<sup>307</sup>

It is important to note that, despite the key intention of the AIFMD anti-asset stripping rules targeting the ability to make improper distributions to shareholders that would be typically performed to obtain a quick repayment of the acquisition debt or a fast profit, the asset stripping rules do not directly prohibit “asset stripping”. An AIF has the liberty to sell the portfolio company after its acquisition, subject to applicable company and insolvency law. In addition, an AIF remains entitled to repay the debt from annual profits. Furthermore, the restrictions imposed do not prevent all distributions within the two-year period. In particular, the key principles of the Second Company Law Directive should be applied in so far that “distributable profits” under Article 30 of the AIFMD should include profits to the extent the portfolio company’s net assets would remain at, or above, the level of the subscribed capital plus non-distributable reserves.

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<sup>302</sup> Pursuant to Article 30(3)(a) of the AIFMD, the term “distribution” shall include, in particular, the payment of dividends and of interest relating to shares.

<sup>303</sup> Pursuant to Article 30(3)(b) of the AIFMD, the provisions on capital reductions shall not apply on a reduction in the subscribed capital, the purpose of which is to offset losses incurred or to include sums of money in a non-distributable reserve provided that, following that operation, the amount of such reserve is not more than 10% of the reduced subscribed capital.

<sup>304</sup> See Article 30(2) of the AIFMD. Pursuant to Recital (58) of the AIFMD, the notification and disclosure requirements and the specific safeguards against asset stripping in the case of control over a non-listed company or an issuer should be subject to a general exception for control over small and medium-sized enterprises and special purpose vehicles with the purpose of purchasing, holding or administering real estate.

<sup>305</sup> Distributions have a broad reach, including dividends (and “interest” on shares), capital reductions, share redemptions and purchases of own shares. More specifically, the AIFMD mentions (a) distributions to shareholders made when on the closing date of the last financial year the net assets as set out in company’s annual accounts are, or following such distribution would become, lower than the amount of the subscribed capital plus those reserves which may be not distributed under the law or the statutes. (b) any distribution to shareholders the amount of which would exceed the amount of the profits at the end of the last financial year plus any profits brought forward and sums drawn from reserves available for this purpose, less any losses brought forward and sums placed to reserve in accordance with the law or the statutes and (c) to the extent that acquisitions of own shares are permitted, the acquisitions by the company, including shares previously acquired by the company and held by it, and shares acquired by a person acting in his own name but on the company’s behalf, that would have the effect of reducing the net assets below the amount set out in point (a) above. See Article 30(2) of the AIFMD.

<sup>306</sup> One interviewee criticised that even within one Member State legal experts may give different interpretations of the requirements. See KPMG Report, p. 77.

<sup>307</sup> See KPMG Report, p. 98.

### 2.5.3 Level playing field for AIFs and other investors after acquisition of control

Apart from the impact of the AIFMD on the protection of non-listed companies and issuers, the AIFMD requires to assess the level playing field between AIFs and other investors after the acquisition of major holdings in or control over such non-listed companies or issuers.

Recital 57 of the AIFMD sets out that when transposing this Directive into national law, the Member States should take into account the regulatory purpose of the provisions of Section 2 of Chapter V of the AIFMD and take due account in this context of the need for a level playing field between EU AIFs and non-EU AIFs when acquiring control in companies established in the Union. In accordance with Recital 58, the notification and disclosure requirements and the specific safeguards against asset stripping should also apply without prejudice to any stricter rules adopted by Member States. On this basis, Member States had three options for the transposition of the “asset stripping” provisions of the AIFMD<sup>308</sup>: first, proceed with the transposition of the sole rules of the AIFMD; second, extend the provisions to acquisitions performed by non-EU AIFs in order to provide a “level-playing field” between EU and non-EU AIFs; or further expand the provisions to all acquisitions, thus extending the level-playing field to acquisitions by any acquirers rather than solely the AIFs.

The majority of respondents stated that the AIFMD had not discouraged investments via EU AIFs, although it is notable that 20% of respondent investment managers/advisors indicated that the AIFMD had caused them somewhat to restrict their service offerings to private equity funds.<sup>309</sup> Only one interviewed stakeholder noted that the AIFMD’s additional requirements for investment in non-listed entities create unnecessary burdens and impediments for the sector, in contrast to the aims of the CMU and the various attempts to assist small enterprises in securing capital investment. In this regard, the compatibility with national constitutional rights and European law was discussed by legal commentaries, but not concluded.<sup>379</sup> There is, no sufficient empirical evidence to deduce the existence of the prevailing unlevel playing field.

### 2.5.4 Impact on private equity and venture capital market

Private equity or venture capital fund managers fall within the scope of the AIFMD when the assets under their management reach the established thresholds.<sup>310</sup> Sub-threshold AIFMs are exempt from the vast majority of the AIFMD obligations, including those relating to investments in non-listed companies.<sup>311</sup> However, they are precluded from using the AIFM passport, unless they decide to opt-in under the AIFMD.<sup>312</sup> This is of a particular relevance to the European venture capital fund sector, 98% of which manages a portfolio of venture capital funds that are below the mentioned threshold.<sup>313</sup> For these smaller managers EuVECA Regulation<sup>314</sup> offers a solution by providing a marketing passport permitting cross-border fundraising.<sup>315</sup>

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<sup>308</sup> Supra 108, p. 665.

<sup>309</sup> KPMG Report, p. 232.

<sup>310</sup> Article 3 of the AIFMD.

<sup>311</sup> Section 2 of Chapter V of the AIFMD.

<sup>312</sup> Point 4 of Article 3 of the AIFMD.

<sup>313</sup> Information Invest Europe.

<sup>314</sup> Regulation (EU) No 345/2013 of the European Parliament and of the Council of 17 April 2013 on European venture capital funds.

<sup>315</sup> Regulation (EU) No 345/2013 on European venture capital funds and Regulation (EU) as amended by Regulation (EU) 2017/1991 of the European Parliament and of the Council of 25 October 2017.

The effectiveness of the EuVECA legal framework has been recently assessed leading to the amendments of the EuVECA Regulation.<sup>316</sup> The introduced changes aim provide a further support to the development of venture capital fund market in Europe.

Analysis of national private equity and venture capital markets demonstrates a general trend of these markets growing in terms of AIFs and AuM.<sup>317</sup> For example, in Hungary private capital funds increased their portfolios from HUF 3 bn at the end-2015 to HUF 40 bn by end-2016. German private equity market has been growing since 2011 with € 42 bn invested during the period 2014-2018 with € 9.6 bn invested in 2018 alone.<sup>318</sup> The French market followed the trend where private equity investments increased from € 6.5 bn in 2013 to € 12.4 bn by end of 2016. Spain recorded extremely positive performance of private equity and venture capital sectors leading to an increase from € 2.7 bn invested in 2015 to € 4.9 bn in 2017.

Similarly, upwards figures have been recorded in the venture capital market in different Member States indicating that increasingly investment opportunities have been seized by the venture capital funds managers. In Hungary a number of venture capital funds increased from 17 at end-2012 to 38 in 2014, although since then halted and have undergone a certain transformation towards private equity type of strategy. In Germany this market has been steadily increasing from € 6.7 bn in 2014 to € 10.4 bn in 2017. Seed investment has reportedly grown 300 % to GBP 56 mio. In this sense, the AIFMD does not appear as having hindered the activities in the private equity and venture capital markets. In fact, majority of the respondents to the General Survey stated that they have not been discouraged from making investments in private companies via EU AIFs.<sup>319</sup>

In spite of the described market trends, the feedback in the General Survey as regards the specific provisions governing acquisitions in non-listed companies was overwhelmingly negative.<sup>320</sup> The AIFMD rules governing investments in non-listed companies were considered by majority of respondents as unnecessary and overtly burdensome. They were said to lack clarity, which is alleged to be further clouded by an incoherent adaptation of the legal concepts into the national legal systems.<sup>321</sup> An example of a ‘non-listed company’ was brought up as having different meanings in different national legal systems. It was further noted that since no similar requirements apply in foreign jurisdictions, European private equity industry is put at a disadvantage.<sup>322</sup> Indeed, some evidence suggests that investment managers are poached to establish private equity funds in foreign jurisdictions and then market them into the internal market via NPPRs thus avoiding compliance with the AIFMD.

In general, from the private equity sector’s perspective, the AIFMD is considered as not explicitly taking into account all specificities of managing such investments. As discussed in the previous sections, the private equity sector has been continuously advocating for fine-

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<sup>316</sup> Regulation (EU) 2017/1991 of the European Parliament and of the Council of 25 October 2017 amending Regulation (EU) No 345/2013 on European venture capital funds and Regulation (EU) No 346/2013 on European social entrepreneurship funds.

<sup>317</sup> An detailed of developments in the private equity and venture capital markets in Austria, Cyprus, Denmark, France, Germany, Hungary, Italy, Malta, Spain, the UK in the KPMG Report pp. 228 - 230.

<sup>318</sup> BVK, The German Private Equity Market in 2018. Retrieved from: <https://www.bvkap.de/en/market/statistics>.

<sup>319</sup> KPMG Report, p. 232.

<sup>320</sup> Ibid., p. 98.

<sup>321</sup> Ibid., p. 231.

<sup>322</sup> Ibid., pp. 100 and 232.

tuning of the AIFMD rules on supervisory reporting, depository, risk management and remuneration to accommodate the specifics of their sector and lift off unnecessary charges. Furthermore, the academic literature and stakeholder feedback regret that ‘small’ fund managers, which do not adhere to the regulatory parameters of EuVECA Regulation, are not able to market their funds in other Member States under the same conditions as the local funds.<sup>323</sup>

Finally, incoherent transposition and application of the AIFMD, and in particular gold plating, across the Member States is cited as undermining efficiency of the AIFM marketing passport<sup>324</sup>. In this respect, market data reveal a low percentage of funds raised (in terms of amount) by private equity and venture capital funds across borders.

‘Between 2011 and Q3 2015 for the vast majority of Member States, European venture capital funds were almost entirely relying for their fundraising on national investors and investors based in Luxembourg. Only a small percentage of the total amounts raised came from investors in another country. Putting Luxembourg aside (where much of the small amount of funds raised came from Belgium and the United States), only in two Member States did cross-border fundraising by venture capital funds amount to 20% or more: the United Kingdom and the Netherlands’.<sup>325</sup>

Two mentioned initiatives of the European Commission responded to these raised issues by proposing to improve the EuVECA regulatory regime and to further dismantle barriers to cross-border marketing of investment funds. It is still premature to judge whether the recent changes to the EuVECA and the AIFMD legal frameworks were successful in improving cross-border activities of private equity and venture capital funds.

## **2.6 AIFMD impact on investment in or for the benefit of developing countries**

As discussed in detailed above, contrary to the UCITS regulation, the AIFMD does not impose any rules as regards eligible assets or portfolio composition of AIFs. In principle, AIFMs may invest in any asset anywhere around the globe, comprising developing countries. In this context, no observable effect of the AIFMD in terms of investments in developing countries or for their benefit could be established.

More than half of respondents to the General Survey did not have an opinion whether their investment in or for the benefit of developing countries has increased since the application of the AIFMD. One third did not observe any change in this respect. 5% of the participants observed an increase and 7% a decrease of such investments.<sup>326</sup> Based on the available evidence it can be concluded that the AIFMD did not hinder investing in or for the benefit of developing countries.<sup>327</sup>

## **2.7 Supervisory cooperation**

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<sup>323</sup> Supra 105, p. 701.

<sup>324</sup> Cf. Section 2.2.

<sup>325</sup> Impact Assessment accompanying Proposal for Regulation of the European Parliament and of the Council amending Regulation (EU) No 345/2013 on European venture capital funds and Regulation (EU) No 346/2013 on European social entrepreneurship funds, COM (2016) 461, 14.7.2016.

<sup>326</sup> KPMG Report, p. 260.

<sup>327</sup> Ibid.

Monitoring of systemic risk and effective supervision of the AIF sector requires a functioning supervisory cooperation. The AIFMD lays down rules on the NCAs' competences and on their interaction assigning an important role to ESMA.

The AIFMD requires NCAs to cooperate with each other, ESMA and the ESRB.<sup>328</sup> In particular NCAs must communicate any information relating to individual or multiple AIFMs that is relevant for the stability of systemically relevant financial institutions and for orderly functioning of markets in which those AIFMs are active.<sup>329</sup> A supervisory cooperation is required for on-the-spot verifications, which can be refused on the grounds of negative effects to sovereignty, public order to security and if there are judicial proceeding on-going or final judgement has been rendered for the same matter.<sup>330</sup> ESMA may develop draft implementing technical standards regarding common procedures for supervisory cooperation in the cases of on-the-spot cooperation.

The AIFMD provides many cases where ESMA is empowered to draft technical standards to further a uniform implementation of the AIFMD rules.<sup>331</sup> In addition, it may provide guidelines for the NCAs on the authorisation powers and on the reporting obligations and on other matters thus ensuring a common understanding of the applicable rules.<sup>332</sup> In case of disagreement among the NCAs, if approached, ESMA plays an important role of a mediator with an ensuing binding decision.<sup>333</sup> Moreover, it is required to conduct annual peer-reviews on supervisory activities of NCAs.<sup>334</sup> ESMA is also empowered to take measures against individual non-EU AIFs or non-EU AIFMs should their activities threaten the orderly functioning and integrity of financial market or stability of the financial market of the Union.<sup>335</sup> It shall also draft a report annually on the administrative measures taken or penalties imposed in each Member State due to the breaches of the national rules implementing the AIFMD.<sup>336</sup>

It is clear from the breadth and depth of the ESMA's output that it has proven to be a valuable facilitator in filling the gaps of the AIFM regulatory environment. Bringing the NCAs together to exchange their views ESMA is a forum of a reliable technical expertise.<sup>337</sup> An overwhelming majority of NCAs confirm that they comply with the AIFMD Cooperation Guidelines.<sup>338</sup> Nevertheless, the experience or rather the lack of it, does not allow appraising an overall efficacy of the AIFMD provisions governing supervisory cooperation among the NCAs.

According to the findings of the ESMA's study on home-host responsibilities under UCITSD and AIFMD<sup>339</sup> a large number of NCAs do not apply any particular measures for cross-border activities but consider those as a contributing factor in a risk-based supervisory approach.<sup>340</sup>

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<sup>328</sup> Article 50(1) of the AIFMD.

<sup>329</sup> Article 53(1) of the AIFMD.

<sup>330</sup> Article 54 of the AIFMD.

<sup>331</sup> See for example, Articles 4, 7, 8, 31-35, 37 etc. of the AIFMD.

<sup>332</sup> Point (1) of Article 47 of the AIFMD.

<sup>333</sup> Point (10) of Article 45 and 55 of the AIFMD. See also Article 19 of Regulation (EU) 1095/2010.

<sup>334</sup> Article 38 of the AIFMD.

<sup>335</sup> Article 47 of the AIFMD.

<sup>336</sup> Article 48(3) of the AIFMD.

<sup>337</sup> Point (15) of Article 40, point (6) of Article 50 of the AIFMD.

<sup>338</sup> KPMG Report, p. 163.

<sup>339</sup> ESMA, Notification frameworks and home-host responsibilities under UCITS and AIFMD, ESMA thematic Study among National Competent Authorities of April 2017, ESMA 34-43-340.

<sup>340</sup> Ibid.

By the end of reporting period on 30 June 2016 NCAs have applied the same approach to AIFMs and their marketed AIF as to the UCITS management companies.<sup>341</sup> The study did not reveal any particular practice of cross-border cooperation beyond a few anecdotal cases.<sup>342</sup> Therefore, the whole range of the cooperation arrangements laid down in the AIFMD has not been tested yet.<sup>343</sup> The lack of ESMA's practical experience with certain AIFMD rules point to therein-inbuilt barriers.

As mentioned, ESMA may request an NCA to impose marketing restrictions on a non-EU AIF or a non-EU AIFM or do it itself, where there is a threat of excessive concentration of risk or where activities constitute an important source of counterparty risk to a credit institution or other systemically relevant institution.<sup>344</sup> ESMA's experience in taking an action on this basis in the context of MiFID has proven to encounter an unsurmountable burden of proof.

Finally, given that the AIFMD third country passport has not been activated yet, ESMA responsibilities in this area cannot be appraised.

It can be concluded that, while the AIFMD rules on supervisory cooperation lay down the necessary framework, the efficacy of all of those rules has not been put to test yet. It is certain, however, that ESMA is playing a central role in forging greater convergence of the AIFMD standards in the internal market by bringing the NCAs views together.

## 2.8 Technological Developments

Given the objectives of the AIFMD and its effects on investor protection, market disruption and competition, the monitoring of systemic risk and potential impacts on investors, it is appropriate to evaluate the functioning of the AIFMD from the viewpoint of technological developments.

### *a) Distributed ledger technology*

Distributed ledger technology (DLT) is a digital system for recording the transactions whereby details of the transactions are recorded in multiple places at the same time.<sup>345</sup> DLT or any alternative technology can have a potential over the next few years to induce significant changes in the way in which the infrastructure of financial markets operates, including custody of assets.

Using DLT fund managers and distribution counterparts could reduce the cost and time associated with the transactions. For instance, in case of a DLT powered platform transaction information can be routed, recorded, reconciled and monitored securely and in close to real time. Apart from processing and transmitting information, DLT could reduce costs related to 'know your consumer' process, AML compliance, lower fund administration costs and costs of reporting and compliance for asset managers. It can also be argued that for players in the distribution value chain, the shift to DLT could create a large opportunity to automate the

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<sup>341</sup> KPMG Report, p. 164.

<sup>342</sup> Ibid., p. 165.

<sup>343</sup> Ibid.

<sup>344</sup> Article 47 of the AIFMD.

<sup>345</sup> Unlike traditional databases, distributed ledgers have no central data storage or administration functionality. The distributed ledger database is spread across several nodes (devices) on a peer-to-peer network, where each replicates and saves an identical copy of the ledger and updates itself automatically. Security is normally achieved thanks to cryptographic encryption.

more commoditised parts of the business to focus on adding value by, for instance, providing more targeted investment advice and intelligent interface.<sup>346</sup>

There are certain cases of DLT use in providing a platform for high quality, trusted and timely transaction data enabling asset managers and stakeholders to transact on a peer-to-peer basis.<sup>347</sup> Investment managers and other stakeholders continue innovating with DLT uses through tokenisation and building platform-based ecosystems meeting specific needs.<sup>348</sup> In the context of reporting, a lack of consistency and coherence and the need for stronger integration in technological terms has clearly been pointed out in the General Survey.<sup>349</sup>

#### *b) Adoption of crypto-assets, digital assets and tokens*

The terms ‘crypto-asset’, ‘crypto-currencies’, ‘digital asset’ and ‘digital token’, which are often used intermittently, commonly refer to virtual digital assets (e.g. Bitcoin, Dash, Cardano)<sup>350</sup>. The characteristics and uses of crypto-assets have evolved rapidly and can be seen in much wider range of contexts, rather than exclusively asset management, for example as alternative means of capital raising (sometimes termed ‘initial coin offerings’ or ‘ICOs’), means of payment and other uses. There are now more than 2,000 privately issued crypto-assets and some public authorities are actively considering piloting the issuance of crypto-assets.

Notably, the recent growth in cryptocurrencies and cryptocurrency-related products has attracted significant interest among sponsors in offering funds that would hold these new digital products. Given the fact that there are a number of significant investor protection issues that need to be examined before sponsors begin offering these funds to retail investors (problematic issues such as valuation, liquidity, custody, conflicts of interest, product manipulation, etc.<sup>351</sup>), national regulators and the ESAs, i.e. ESMA, EBA and EIOPA have so

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<sup>346</sup> For instance, FundsDLT is a digital funds distribution platform that links asset managers, transfer agents, investors, custodians, regulators and other stakeholders through a DLT-enabled platform and leveraging upon the smart contracts and DLT. Retrieved from: [<https://www.fundsdltd.net/>].

<sup>347</sup> For example, Aprexo Ltd is developing a cloud-based multi-asset investment SAAS platform with DLT capabilities to help asset managers, regulators and market infrastructure providers to better process transaction information and increase modelling capabilities and portfolio analytics. Retrieved from: [<https://www.aprexo.com/>].

<sup>348</sup> As an example, NowCP, a new digital marketplace for the issuance and negotiation of short term debt securities (commercial paper) in Europe. NowCP platform is designed to provide funding and investment service, from negotiation to central bank currency settlement, and integrates a central securities depository based on blockchain technology. NowCP platform involves Orange, Amundi, BNP Paribas, Crédit Agricole CIB, OFI AM and Natixis, among others, and is claimed to be backed by the French AFM. Source: [<https://nowcp.eu/>] (Available: 11 June 2019).

<sup>349</sup> See 4.8 in Section 1 of the KPMG Report. In particular, overlapping reporting obligations in other legislation is seen as deviating from a coherent approach. Survey respondents and interviewees requested that decisions about amendments to the reporting requirements should take into account the significant sunk costs in implementing the reporting systems, for AIFMs, NCAs and ESMA, and the additional costs that would be incurred in making changes, especially if those changes are made in a piecemeal fashion. They also suggested that reporting should be looked at in the round for asset and fund managers, and should consider (more) efficient use of new technologies

<sup>350</sup> In general, crypto assets are commonly represented by pieces of unique digital code and are stored and transferred in internet-based databases, in particular of the blockchain or DLT type.

<sup>351</sup> Looking at risks, the crypto-asset markets are still deemed to be relatively very small and are deemed not to pose financial stability risks. The money-laundering risks are being addressed at EU and international level. The consumer protection and market integrity risks identified by the ESAs are currently concentrated in services relating to crypto-asset issuance, custodian wallet provision and trading platforms. Some of the risks were underlined in ESMA’s Advice on Initial Coin Offerings and Crypto-Assets. 9 January 2019. ESMA50-157-1391.

far taken a careful approach. In this respect, in 2018 the ESAs have issued a joint pan-European consumer warning, mirrored by that issued by EU national competent authorities, on the risks of buying crypto-assets.<sup>352</sup> Nevertheless, ESMA and the NCAs have shown openness to considering whether and to what extent certain crypto- and digital assets can be covered by the scope of existing EU legislation.<sup>353</sup>

*c) EU financial services acquis*

From the perspective of the AIFMD, a few uncertainties persist in so far as the crypto-assets represent or serve as an AIF for the purposes of the AIFMD:

- Liquidity management: AIFM must ensure that the liquidity profile of the investment of the AIF complies with its underlying obligations. The lack of liquidity per se is not an issue as the AIFMD requires only that the liquidity of the assets be consistent with the redemption policy of the AIFs.
- Valuation: AIFM ensures that appropriate and consistent procedures are established so that a proper and independent valuation of the assets of the AIF can be performed. An uncertainty can occur on the proper valuation and the independence of the valuation of crypto-assets.
- Conflict of interests: AIFM must maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to identify, prevent, manage and monitor conflict of interests in order to prevent them from adversely affecting the interest of the AIFs and their investors. An uncertainty can occur regarding the monitoring of those potential conflicts of interest.
- Depositary: AIFMs are required to appoint a depositary for each their managed AIF. The assets of the AIF must be entrusted to the depositary for safekeeping. An uncertainty can occur whether the depositary can performed this task for crypto-assets and also whether the safekeeping can be entrusted.

Against this background, one could possibly continue exploring these topics, at both the European Commission and ESAs level, with a view of providing legal certainty for AIFs investing in crypto-assets. The European Commission is working on a legislative proposal regarding crypto-assets and the new technologies, which have an impact on how financial assets are issued, exchanged, shared and accessed.

*d) Big data, automation and robo-advice*

Big data, various forms of artificial intelligence (AI) and machine learning, automation, advanced analytics techniques and process automation are already transforming the asset management industry. Asset managers are increasingly adopting robo-advice capabilities with low-cost and reasonably effective alternatives to traditional asset management programs. A typical robo-advisory process involves initial investor screening, implementation of investment strategies, and monitoring and evaluation of these strategies.

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<sup>352</sup> ESMA, EBA and EIOPA warn consumers on the risks of Virtual Currencies, retrieved from: [[https://www.esma.europa.eu/sites/default/files/library/esma50-164-1284\\_joint\\_esas\\_warning\\_on\\_virtual\\_currenciesl.pdf](https://www.esma.europa.eu/sites/default/files/library/esma50-164-1284_joint_esas_warning_on_virtual_currenciesl.pdf)].

<sup>353</sup> ESMA's Advice on Initial Coin Offerings and Crypto-Assets. 9 January 2019. ESMA50-157-1391, retrieved from: [[https://www.esma.europa.eu/sites/default/files/library/esma50-157-1391\\_crypto\\_advice.pdf](https://www.esma.europa.eu/sites/default/files/library/esma50-157-1391_crypto_advice.pdf)].



The joint committee of the three ESAs launched an assessment of robo-advice, aimed at gauging whether any action was required to harness its potential benefits and mitigate its risks. At the end of 2016, the ESA committee decided to continue monitoring robo-advisory services, but not to take any cross-sectoral regulatory or supervisory action.<sup>354</sup>

At this moment there is no evidence that the AIFMD is preventing operations automation or the application of innovative technologies. In this regard, it should be noted that the AIFMD is technology-neutral, i.e. it regulates substance over form and does not favour any specific data format or technological means. As a result, once such technologies are ripe for the use they may be implemented across wider scales to lower down compliance, distribution, running and other costs. Furthermore, digital advice services are subject to the same regulatory requirements as traditional financial advisors and are therefore supervised by the same NCAs as traditional financial advisors. In a 2016 survey by the IOSCO, supervisors in the US, the UK and Germany reported that existing rules appear to be sufficient, for now at least, to cover automated advice tools.<sup>355</sup>

### 3. CONCLUSIONS

Overall, it is concluded that the AIFMD is delivering on its objectives to bring the AIF market into a more coordinated supervisory framework based on a harmonised set of standards, promoting a high-level investor protection and facilitating greater integration of the AIF market. Market data shows that assets under the management of AIFs are growing, as are the cross-border activities of AIFMs.

The AIFMD provides a high-level investor protection. Rules on conflicts of interest, disclosure and transparency requirements all serve to protect investor interests, which is beneficial for building confidence in financial markets. This SWD confirms that the valuation rules, which are necessary for establishing each investor's share in a given AIF and for monitoring the AIF's performance, brought greater discipline and structure into the AIF asset valuation process. A dedicated regime regulating the functions and liability of depositaries proved to be another effective measure for enhancing investor protection.

The AIFMD requirements on supervisory reporting and on risk and liquidity management are valuable from a macro-prudential point of view and can help identify and mitigate financial stability risks. In 2019, ESMA published its first Annual Statistical Report on EU Alternative Investment Funds, which aggregates AIFs supervisory reporting data providing market participants and investors, as well as supervisors and policy makers, with information on market developments.<sup>356</sup>

However, a case is made for more streamlined reporting requirements, given identified overlaps with requirements under other Union laws, such as statistical reporting under the ECB regulations. IOSCO work, particularly on leverage, which focuses on the type of data to be provided to supervisors and provides further detailed input that concerns the AIFMR reporting template.

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<sup>354</sup> ESMA. EIOPA. EBA. Report on Automation in Financial Advice, 2016, retrieved from: [[https://esas-joint-committee.europa.eu/Publications/Reports/EBA%20BS%202016%20422%20\(JC%20SC%20CPFI%20Final%20Report%20on%20automated%20advice%20tools\).pdf](https://esas-joint-committee.europa.eu/Publications/Reports/EBA%20BS%202016%20422%20(JC%20SC%20CPFI%20Final%20Report%20on%20automated%20advice%20tools).pdf)]

<sup>355</sup> Update to the Report on the IOSCO Automated Advice Tools Survey, retrieved from: [<https://www.iosco.org/library/pubdocs/pdf/IOSCOPD552.pdf>]

<sup>356</sup> Supra 10.

As regards leverage calculations, the SWD concludes that the leverage calculation methods – the gross and commitment methods – currently provided in the AIFMR are satisfactory. The work of the FSB and IOSCO as well as recommendations of the ESRB concerning improved measures for assessing macro-prudential risks are also taken into account.<sup>357</sup>

Increasing non-bank lending raises concerns regarding financial stability as well as level playing field among the financial intermediaries active in the credit market. On this basis, some stakeholders call for consideration of Union standards for loan originating AIFs and supplementing the AIFMR reporting template with additional data fields relating to loan-origination by AIFs.

The SWD identifies a number of deficiencies that undermine the effectiveness of the AIFM passport. Gold-plating and the lack of a common understanding among NCAs of certain AIFMD rules or concepts as well as limited coverage of the AIFM passport produce inefficiencies. Sub-threshold AIFMs may have difficulties in satisfying all the requirements of the AIFMD and as a result refrain from cross-border activities while the authorised AIFMs are permitted to market their AIFs cross-border only to professional investors.

Similarly, the absence of an EU passport for depositaries leaves the market for depositary services fragmented and particularly impacts the supply side of these services in smaller markets. The affected Member States would welcome an introduction of the depositary passport, whereas others prefer securities laws to be harmonised before introducing such a passport. Furthermore, there is a lack of clarity and regulatory gaps in relation to tri-party collateral management and custody services provided by central securities depositories.

Moreover, there are some calls to refine the allegedly binary nature of the valuation rules, whereby it is understood that a combined use of internal and external valuers is excluded, as well as uncertainty around the liability of external valuers due to a lack of the EU harmonisation of these issues.

The remuneration rules provided in the AIFMD are judged as having achieved the objective of bringing about a more risk-conscious approach to the management of AIFs. Nevertheless, following the changes to the CRD<sup>358</sup>, which include amendments to the rules on remuneration for staff of credit institutions, there is room for improvement regarding the measure of proportionality provided in the AIFMD.

Another level playing field issue relates to the national private placement regimes (NPPRs), which permit access of third country AIFMs and/or AIFs to the markets of individual Member States. NPPRs differ across Member States and, more importantly, implement only a very limited number of the AIFMD requirements thus creating an uneven playing field for EU AIFMs. On the other hand, the NPPRs proved to play an important bridging role while the AIFMD passport for the third country entities has not been activated yet by means of a delegated act. As a result, investors in the permitting Member States have been able to access global markets for financial services allowing them to better diversify their investment allocation.

The SWD confirms the key role that ESMA has been playing in promoting supervisory convergence among the NCAs as regards application of the AIFMD.

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<sup>357</sup> Supra 9.

<sup>358</sup> Supra 131.

Contrarily, it was not possible to establish with the requisite certainty the value-added of the AIFMD rules for investment in private companies, nor whether the AIFMD had a positive (or negative) impact on investments in, or for the benefit of, developing countries.

Examining the AIFMD from the perspective of technological developments, it seems that those are set to provide new opportunities for the alternative asset management sector. Distributed ledger technology (DLT) may enable stakeholders to transact on a peer-to-peer basis by relying upon trusted high-quality real-time information. In the context of supervisory reporting, technology can also help to achieve stronger integration and consistency. There is no evidence presented suggesting that the AIFMD is not technology-neutral or that it prevents the automation of operations or the application of innovative technologies.

It transpires from the responses to the General Survey and from bilateral and multilateral meetings with the European Commission that stakeholders, initially resistant, seem to have recognised the added value of the AIFMD. Moreover, a number of issues that had been raised since the implementation of the AIFMD have been already solved by the recently adopted Union laws.

The Cross-Border Fund Distribution of Investment Funds package was adopted *inter alia* to increase transparency in relation to regulatory fees charged by NCAs for processing AIF notifications and in relation to national marketing rules.<sup>359</sup> The AIFMR has been recently amended to clarify asset segregation requirements where custody of assets is delegated to a third party.<sup>360</sup> The recent amendments to the CRD provides that AIFMs belonging to the same corporate group or conglomerate will have to apply the AIFMD rules on remuneration thus avoiding their being subject to concurrent set of rules regulating distinct financial intermediaries.<sup>361</sup> The EU regulation on sustainability related disclosures in the financial services sector is set to ensure coherence across different EU regulatory frameworks.<sup>362</sup> The recently changed European Venture Capital Fund Regulation opened up the use of the designations ‘EuVECA’ to managers of collective investment undertakings authorised under the AIFMD and expanded investment parameters.<sup>363</sup>

Other issues raised in this SWD, however, may possibly warrant further action at the Union level to support the further development of the EU AIFs market and to respond to new technological developments ensuring that the AIFMD framework is fit for purpose.

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<sup>359</sup> Supra 66.

<sup>360</sup> Supra 216.

<sup>361</sup> Supra 131.

<sup>362</sup> Supra 164.

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