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Highlights from ESMA's feedback on the AIFMD

31 August 2020

6 MINUTES

On 18 August 2020, ESMA published a letter to the European Commission in which it proposes improvements to the Alternative Investment Fund Managers Directive, the AIFM Directive (or in short: the AIFMD). It did this in the context of the ongoing review of the AIFMD. However, the letter is also very relevant for UCITS management companies, as ESMA also includes the UCITS Directive in the majority of the feedback. The letter is chock-full of interesting observations from ESMA, which do justice to what we also see in practice. It is difficult to choose, but we will highlight four topics.

1.Harmonization AIFMD and UCITS

ESMA has established that the rules of the AIFMD are more granular or specific in certain areas as opposed to the UCITS Directive, particularly in the areas of risk management and outsourcing. ESMA proposes to investigate further harmonization of the AIFMD and UCITS regulations. That seems reasonable to us to the extent it relates to organizational requirements. However, this harmonization could also potentially mean that the stricter UCITS rules in the sense of investment protection (such as information provision) find their way to the AIFMD. We would not welcome the latter, because the UCITS framework focuses on retail investors and the AIFMD only on professional investors.

2. Individual investment mandates

ESMA recognizes that there is a lack of clarity about the rules that apply when a fund manager (both under the AIFMD and under the UCITS Directive) also manages individual mandates. Both the AIFMD and UCITS Directive allow a fund manager to provide individual investment services (discretionary portfolio management and investment advice) in addition to the collective management of investment funds. What requirements the fund manager must comply with in such case, however, is subject uncertainty and debate.

We particularly recognize the situation referred to by ESMA in which an individual mandate pertains to an asset class which is by itself not subject to regulation in case of individual investment services. The clearest example of this is real estate. Under existing rules, financial regulations do not apply to the provision of investment services with respect to a direct real estate portfolio for an investor. Only if investment services are carried out with regard to a portfolio consisting of financial instruments (such as shares, bonds and units), the rules for the revised Markets in Financial Instruments Directive (MiFID II) must be complied with. However, the way in which the AIFMD and UCITS Directive are drafted may give the impression that if a real estate fund manager also

manages an individual mandate focused on direct real estate, this manager should also apply the MiFID II rules. It is evident to us that this cannot be the intention, as it would mean applicability of MiFID II with respect to direct real estate. ESMA is not so explicit about this, but we do expect this letter to be a reason to adjust the AIFMD along “our line”.

3. Delegation; supporting tasks and white-label service providers

Delegation by fund managers has been a difficult subject within the AIFMD from the outset. For market parties, but certainly also for regulators. There are therefore many differences in the way national supervisors apply the delegation rules. And that obviously does not benefit the level playing field. It is therefore no surprising to us that findings and recommendations in this area make up a relatively large part of ESMA’s letter. We list 2 of the 7 observations that concern outsourcing:

- *Supporting tasks*: The scope of the delegation rules appears to be a continuous debate between mainly national supervisors and ESMA. ESMA has indicated in its Q&A on the AIFMD that the general delegation rules from the AIFMD must be applied to all Annex I AIFMD tasks that are delegated to a third party. That is also the interpretation that is applied in the Netherlands. In our experience, this view is not applied in this way by colleagues in other Member States, because this view would conflict with the AIFMD. ESMA therefore recommends that its Q&A be codified. In addition, she mentions that in practice questions arise about what ‘supporting tasks’ are that could fall outside the scope of the delegation rules. Examples of apparent differences in insight between national supervisors in this area are legal and compliance tasks performed by group entities, research activities and risk data analyses.

- *White0label service providers*: In some European Member States, such as Ireland and Luxembourg, certain licensed fund managers operate as white-label service providers. They provide a platform to business partners to manage funds, initiated by those business partners, under their license. The risk management is then carried out by the license holder and this license holder is also formally responsible for the portfolio management of the fund. However, the portfolio management is delegated to the “fund sponsor”; the person who set up the fund commercially. It is also possible that the fund sponsor is appointed as an investment advisor. This business model is known by names such as “Host-AIFM”, “AIFM Platform” and “Rent-a Manco”. ESMA indicates that not all national supervisors are convinced that this business model is compliant with the delegation rules of the AIFMD. The AFM belongs to this group of regulators: the Netherlands is therefore not familiar with these types of commercial platforms in the form that they operate in Luxembourg and Ireland. ESMA does not comment on the admissibility of such platforms, but does ask the European Commission for clarity in this area. We welcome this, because the different views in the Member States on this are now very wide. This does not compare well with the degree of maximum harmonization that is

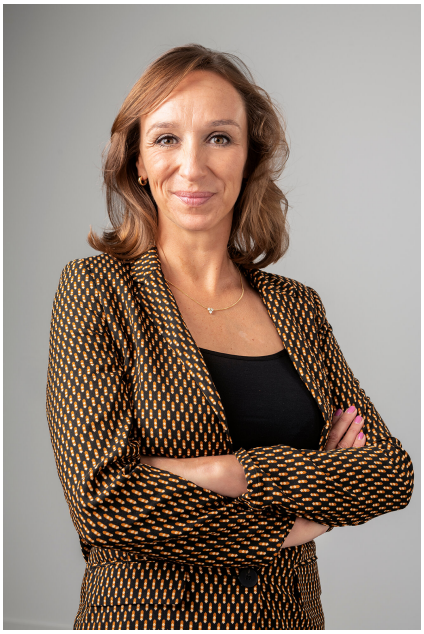
being pursued. ESMA's most concrete concern with regard to platforms focuses on the conflicts of interest associated with this business model. She asks the European Commission to pay special attention to this, if the EC is of the opinion that platforms in themselves are allowed as a business model.

4. Definition of AIF

Finally, we note that ESMA finds that certain definitions, including that of 'alternative investment fund' (AIF), are too vague and not concrete enough. For example, ESMA proposes to make the definition of joint venture more concrete. We share that vision of ESMA. In practice, it is quite often a challenging analysis whether an investment vehicle qualifies as an AIF within the meaning of the AIFMD, or falls outside the AIFMD because it is a joint venture. This is for example the case in respect of club deals. While intuitively many of these club deals are certainly beyond the scope of the AIFMD, it is sometimes difficult to get around on paper given the wide definition and guidance currently available. And that is difficult for a bank that, partly in the context of its own customer due diligence, experiences a duty of care with regard to the regulatory status of an account holder when opening a bank account. In case of doubt and time pressure, there may be a tendency to be "better safe than sorry" and assume a qualification as an AIF. However, we believe that this qualification should not be treated too lightly. It gives a distorted picture of the number of AIFs that are active. In addition, even for fund managers exempted from the full AIFMD regime, the qualification poses a significant compliance burden, particularly in the areas of anti-money laundering and disclosure requirements. Hopefully the improvements proposed by ESMA will contribute to a clearer line with regard to joint ventures / club deals and all sorts of other vehicles operating in a certain grey zone (such as real estate development vehicles).

At the moment, the letter from ESMA does not yet lead to concrete changes in legislation and regulations. But hopefully the European Commission will take the proposed improvements of ESMA to heart and this will lead to changes that are in the interest of the market. We look forward to this with interest.

Specialists



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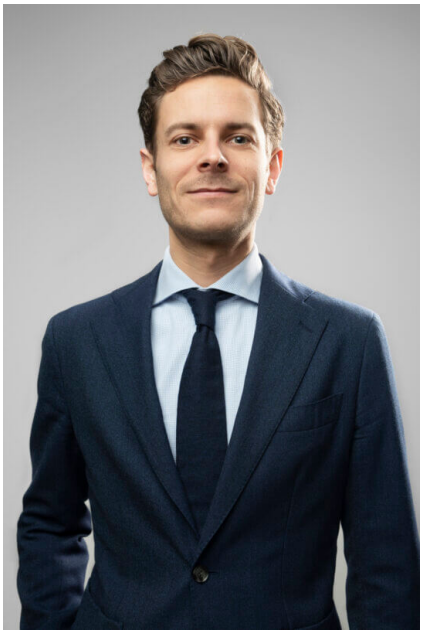

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