UPDATE ON THE AIFMD AND ELTIF REVIEWS

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1. Update on the AIFMD review

1.1 AIFMD objectives and scope

The Commission is currently reviewing the Alternative Investment Fund Managers Directive (AIFMD), which entered into force in July 2011 and became effective in most Member States in 2013 and is considering a range of targeted amendments for improving the functioning of the legal framework.

Alternative Investment Funds (AIFs) are defined in the EU as collective investment funds that are not UCITS. They vary in terms of their investment strategies, markets, asset types and legal forms and include venture capital, private equity funds, real estate funds, hedge funds and funds of funds.

The AIFMD was adopted to address some deficiencies evidenced during the global financial crisis in relation to AIFMs in terms of risk management and transparency and to provide a framework for these activities which are playing an increasing role in the European financial system. Its objectives are to ensure a coherent supervisory approach to the risks that AIFs may pose to the financial system, provide a high-level of investor protection and also facilitate the integration of the EU AIF market.

The AIFMD regulates the activities of the management companies that manage AIFs, whereas AIF products are currently regulated at the domestic level. AIFMD governs the authorisation of AIFMs, allowing them to manage and market AIFs to professional investors across the Union with a single authorisation. It also regulates the operations of AIFMs, imposing notably common risk management and transparency requirements.

1.2 Review process and key themes addressed

A first stage of the review process was completed in June 2020 with the **publication by the Commission of a report[1] on the effectiveness of the AIFMD**. This report concluded that the AIFMD has improved the level of investor protection, facilitated the monitoring of financial stability risks and contributed to the creation of an EU AIF market. The share of cross-border AIFs remains limited but has increased (5.8% of AIFs were registered for sale in 2 or more Member States in October 2019).

Several areas of improvement were identified in this report. These include the AIFMD passporting regime, which is currently impaired by national interpretations and gold plating[2]; the methods of calculation of leverage that need aligning with IOSCO recommendations and further harmonizing across EU fund legislations; reporting and disclosure requirements, which differ across Member States and overlap partly with other EU legislations; and depositary rules which are interpreted differently across the EU and do not accommodate the specificities of all asset classes.

The report also suggested conducting further assessments in two areas that were not included in the AIFMD: the marketing on non-EU AIFs in the EU and the possible need for a depositary passport.

Following this report, **proposals were made by ESMA in August 2020** for improving the AIFMD framework and the supervision of AIFMs in the EU. These proposals build on the conclusions of the June 2020 Commission report and also identify further areas of improvement.

A first additional area identified by ESMA concerns delegation and substance requirements. ESMA recommended a clarification of the maximum extent of delegation that may be allowed for EU AIFs to third-country entities, possibly with quantitative criteria or a list of core functions that cannot be delegated. Legislative amendments to make sure that AIF and UCITS management activities are subject to EU rules, irrespective of the location of the entity to which activities may have been delegated were also proposed by ESMA. A second area is liquidity management tools (LMTs) such as swing pricing, gates or side-pockets which can be used in times of stress to limit liquidity risks or to mitigate their impact. ESMA has proposed to develop an EU legal framework for LMTs in order to ensure their availability across the EU and also clarify responsibilities for supervising their use. Thirdly, ESMA also recommended a clarification of the respective supervisory responsibilities of ESMA and of the national competent authorities (NCAs) concerning the cross-border activities of AIF and UCITS and also a clarification of the obligations for sharing information. Finally, ESMA proposed considering a further alignment of the AIFMD and UCITS regimes in several areas including risk management, liquidity management and delegation.

In October 2020, the Commission subsequently launched a public consultation aiming to gather further input from industry players, investor representatives

1. This report is based on the findings of a study conducted by KPMG in 2019 that included a survey of stakeholders and a fact-finding exercise on the impacts of AIFMD. The study concluded that the AIFMD has been largely effective and has played an important role in creating an internal market for AIFs and in reinforcing and harmonising the regulatory and supervisory framework for AIFMs in the Union. Several areas of potential weakness were however identified, relating to an insufficient harmonisation of rules in areas such as reporting and leverage calculation, the imposition of additional requirements by Member States notably concerning marketing rules and overlapping or overly burdensome reporting and disclosure requirements.

2. Part of these issues have already been picked up in the EU initiative related to the cross-border distribution of funds.

and financial market authorities on potential changes to the AIFMD and on the need for further consistency between the UCITS and AIFMD directives. **The AIFMD public consultation** sought feedback from these stakeholders on a broad range of possible additions and amendments to the AIFMD framework, most of which were identified in the reports mentioned further up published by the Commission and ESMA. Some additional topics were however introduced or further emphasized in the consultation, including: a facilitation of the access of retail investors to AIFs; an introduction of EU-level product rules for certain AIFs such as loan origination AIFs; and a mandatory consideration of ESG factors and sustainability risks in the investment process and in the disclosures of AIFs.

1.3 Initial feedback from industry stakeholders

In their feedback to the AIFMD review consultation, industry representatives generally expressed strong support for the current AIFMD framework, which is considered to have achieved its main objectives in terms of risk mitigation and EU market integration and also helped to create an international footprint for EU AIF funds.

They do not see the need for significant changes to the current Level 1 framework:

- They are first in favour of maintaining the current approach of the directive at manager level. Most industry representatives indeed consider that developing EU level product-specific requirements for AIFs (e.g. for loan-origination funds) would be difficult to implement in an exhaustive way given the diversity of the AIF universe and is not essential, given that AIFs are already widely available at the domestic level.
- Moreover they are in favour of maintaining the current focus on professional investors. Possible additional requirements for retail investors (e.g. specific disclosures or passporting regime) are not considered to be necessary because cross-border demand for AIFs is relatively low and UCITS funds offering a wide range of investment opportunities are usually more suitable for retail investors than AIFs. In addition, a retail regime for AIFs may complicate the approach for professional investors and possibly blur the objectives of the AIFMD directive. Suggestions were also made that the ELTIF structure, once appropriately amended, would be more appropriate for retail investors ready to invest in longer term assets. Some changes may nevertheless be needed in terms of investor classification to ensure that more sophisticated retail investors such as High Net Worth Individuals (HNWI) or family offices can access AIFs more easily, but this may be achieved through the upcoming MiFIDII/MiFIR review.

In a number of other areas industry stakeholders believe that current AIFMD rules should be maintained.

- There is no real support for creating a depositary passport at this stage. Some players are favourable to the concept, which seems consistent with the objective of completing the AIF single market, but do not believe that it is worthwhile reopening the level 1 text for accommodating such an evolution. Many players reject this option, considering that allowing depositary functions to be conducted on a cross-border may reduce legal certainty for investors, potentially reducing their level of protection and may also make the supervision of depositary activities more difficult.
- A review of existing delegation rules in the context of Brexit is also considered to be unnecessary by most asset managers. They instead support an enforcement of existing rules, considering that current AIFMD delegation rules completed by the ESMA 2017 legal opinion are sufficiently clear and robust for defining appropriate delegation and avoiding “letter box” entities in the EU.
- Although there is support for increasing the availability of liquidity management tools (LMTs) in all EU jurisdictions, industry players caution against prescriptive rules at Level 1 in this area that may reduce the flexibility that is needed in using them. Some players also point out that these tools are already available on a domestic basis in the main fund jurisdictions.

Many industry representatives consider that the key issue for enhancing the effectiveness of the directive is to ensure a more consistent enforcement of existing AIFMD rules and to avoid different national interpretations, in order to improve the consistency of rules applying to AIFMs across the EU. This requires Level 2 harmonisation efforts and greater supervisory and enforcement convergence. They however do not believe that granting additional competences and powers to ESMA in the context of AIFMD, beyond those already attributed following the ESAs review, is necessary for achieving this. In addition, more effective data sharing among supervisors is called for, as well as an elimination of overlaps between existing reporting requirements.

Moreover, although consistency could be improved in some areas of the UCITS and AIFMD directives, industry representatives generally do not believe that a complete harmonisation, let alone a merger of the AIFMD and UCITS frameworks, would be appropriate due to their differing investor bases and policy approaches (i.e. manager vs product approach).

Finally while ESG is a major trend in the asset management sector, the suggestion to make ESG and sustainability considerations mandatory for AIFMs (e.g. imposing a quantitative assessment of sustainability risks) is considered to be premature until the new requirements of the EU sustainability framework are fully defined and implemented.

2. Update on the ELTIF review

2.1 Development of the ELTIF market

The European Long-Term Investment Funds Regulation (ELTIF) adopted in April 2015 is a pan-European framework for AIFs that invest in longer term real economy assets such as listed and unlisted SMEs and sustainable energy, transport and infrastructure projects and entities. The ELTIF regime is intended to facilitate investment in these assets by EU and third-country pension funds, insurance companies and professional investors mainly. ELTIFs may also, under certain conditions[3], be marketed to retail investors under a pan-European passport.

The objective of the ELTIF regulation is to provide the EU economy with an additional source of long-term non-banking finance. This is essential for the funding of non-listed SMEs in particular in a context where the EU suffers from a chronic lack of late stage venture capital financing compared to the US in particular[4]. A diversification of funding sources is also needed for infrastructure projects, with the increasing indebtedness of Member States, reducing their capacity to finance such projects. ELTIF moreover provides investors with new opportunities for investing in real economy assets with a long-term maturity. In this respect, ELTIFs have the potential to become an important driver for the Capital Markets Union (CMU) and may also play a key role in the post-Covid EU recovery.

The ELTIF Regulation lays down uniform rules for the authorisation, investment policies and operating conditions of ELTIFs, completing AIFMD requirements with more specific product rules. ELTIFs are closed-ended funds that do not offer redemption rights before the end of the fund's life. To qualify as an ELTIF, a fund must be managed by an authorized AIFM, invest at least 70% of its capital in ELTIF eligible assets, follow diversification and concentration rules, not engage in short selling and observe strict limitations on its use of leverage and derivatives. The regulation also sets out disclosure requirements and transparency obligations.

The success of ELTIFs so far is however quite limited. Only a small number of ELTIFs (approximately 28) have been launched with a relatively small amount of net assets under management (total AuM below ~EUR 2 billion) and a number of Member States have no ELTIFs[5].

2.2 Objectives of the ELTIF review

Reviewing the ELTIF framework is one of the objectives of the new CMU action plan published in September 2020. A review proposal is due to be published by the Commission by Q3 2021[6].

The objective of this review is to enhance the effectiveness of the ELTIF regulatory regime and improve its capacity to channel funding to long-term investment projects and SMEs, while maintaining adequate investor protection. The review is among other things looking into: (i) the main areas where the functioning of the ELTIF framework needs improving; (ii) the extent to which eligible assets and qualifying portfolio undertakings should be updated, as well as diversification, portfolio composition rules and limits on cash borrowing and leverage; (iii) the measures needed for improving the participation and access of retail investors to ELTIFs; (iv) redemption rules and the maturity of investments; (v) distribution and cross-border marketing rules; (vi) fragmentation and gold plating issues; and (vii) mandatory disclosures.

2.3 Initial feedback from industry stakeholders

In their feedback to the ELTIF review consultation, industry representatives generally agreed with the Commission that ELTIFs could potentially play a strong role, alongside UCITS and AIFs, in achieving the objectives of the CMU, provided the framework is amended in order to make ELTIFs more attractive for institutional and retail investors.

Many industry players suggested a broadening of eligible asset classes with a wider variety of fund structures, physical assets and companies that ELTIFs may invest in[7], in order to facilitate diversification. A lowering of the minimum % of eligible assets in which ELTIFs need to invest (70% at present) was also proposed. Some commentators have however pointed out that the main focus of the ELTIF investment universe should remain on long-term assets, such as infrastructures and SMEs, in order to avoid overlaps with other fund frameworks.

The opportunities associated with a development of retail investment in ELTIFs were also emphasized by many industry representatives, for investors looking to invest in less liquid real economy asset classes as a source of diversification. This would require putting in place appropriate safeguards given the illiquid nature of many assets that ELTIFs invest in. Suggestions have been made that ELTIFs could be split into two versions – a retail one and an institutional one – with adapted regulatory protections and minimum investment amounts for each type of investor[8]. The creation of an open-ended retail ELTIF regime with adjusted subscription and redemption terms and a removal of

3. The fund rules must contain a principle of equal treatment for all investors and the ELTIF must not be structured as a partnership. During the subscription period and at least two weeks after the subscription, retail investors must be able to cancel their subscription and have their money returned without penalty. Moreover the ELTIF regulation requires that ELTIF managers should conduct a suitability test to confirm that investment is suitable for retail investors and provide retail investors with "appropriate investment advice". In addition the manager must ensure that a retail investor with a portfolio of up to € 500,000 does not invest more than 10% of his / her portfolio in ELTIFs.

4. Source: Final report of the High Level Forum on the CMU – June 2020.

5. Source: European Commission ELTIF review consultation document.

6. The CMU High Level Forum (HLF) had previously identified the review of ELTIF as one of the potential "game-changers" for the CMU. Two main areas where amendments are needed were identified by the HLF. The first is tackling the barriers to investment, particularly for retail investors, created by ELTIF rules, such as the long lock-up period of ELTIFs, which are closed-ended products and the relatively high entry ticket of 10,000 €. The second issue is the scope of eligible assets which was considered to be too restrictive, preventing ELTIFs from financing certain types of SMEs and infrastructures. The lack of adequate tax incentives was also emphasized by the HLF – e.g. tax exemptions on dividends or capital gains – although this is mainly a matter of domestic policy.

7. The suggestion was made that eligible assets could be broadened to include other types of funds besides ELTIFs, EuVECA and EuSEF funds, as well as non-listed financial start-up companies. Other proposals have been made such as considering lowering the current €10 Mio threshold for investments in 'real assets', redefining the notion of 'qualifying portfolio undertakings' to include financial undertakings, raising the current maximum €500 Mio market cap threshold defining 'qualifying portfolio undertakings' to at least €2 Bio – Source EFAMA's response to the ELTIF consultation.

8. Possibly lowering the current 10,000€ minimum investment to 1000€ for retail investors

current life cycle limitations (the life of current ELTIF funds is currently limited to its longest-dated assets) has been proposed by certain market players. Others have suggested that using closed-ended publicly-traded structures, such as those that exist in the US or UK[9], could be an alternative worth considering for retail investors.

Proposals have also been made for improving the taxation of ELTIFs, including a guarantee of the tax neutrality of the ELTIF structure and possibly a coordination of approaches to tax incentives for ELTIF products at the EU level.

9. Such as US Business Development Company (BDC) funds or UK investment trusts, the shares of which can be bought and sold by retail investors on national securities exchanges.