AIFMD AND ELTIF REVIEWS

Background

A regulator explained the background to the ongoing reviews of the Alternative Investment Fund Managers Directive (AIFMD) and the European Long Term Investment Fund regime (ELTIF). AIFMD was adopted in the aftermath of the global financial crisis. It governs fund managers rather than products. Alternative Investment Funds (AIFs) are funds which are designed mainly for professional investors and invest in less liquid assets than UCITS funds. 10 years later, AIFMD has proved to be a successful framework for AIFs. Europe has a transparent and robust sector that provides the real economy with a growing amount of financing. ELTIFs were launched in 2015 with the intention of supporting investment in longer term real economy assets, but they have not had the same success. In parallel, Europe is experiencing a rapid and deep transformation of its capital markets as a result of Brexit, digitalisation and the implementation of environmental, social and governance (ESG) factors. Making progress on the Capital Markets Union (CMU) is essential for the post-Covid recovery, which will include updating fund policies such as AIFMD and ELTIF in order to enable AIFs to better contribute to the financing of the EU economy.

1. On-going review of the AIFMD framework

1.1 Achievements of AIFMD and the extent of the review needed

A policy maker updated participants on the Commission's progress on the review of AIFMD. The first report was presented to the Parliament and Council in June 2020, and the review will continue after the conclusion of the stakeholder consultation. The review of AIFMD is not a revolution but rather a targeted adjustment. The Commission has not yet decided whether this adjustment will happen through Level 1 or Level 2. Targeted adjustments will only be made in Level 1 if this is necessary, in order to avoid reopening the discussion on the whole directive. The Commission is currently preparing an impact assessment and will soon be releasing a precise timetable for the review. A package of proposed adjustments could be tabled by the end of the current year. At this stage, the Commission's review is seeking to confirm that AIFMD has delivered on its main objectives: i.e. to create an internal market for AIFs that may contribute to the CMU; to reinforce the regulatory and supervisory framework for AIFs; and to introduce more transparency and more information, and therefore more protection, for both investors and managers.

A regulator agreed that AIFMD is a success story. It has provided a solid framework for AIFs in Europe over the last decade and it has enabled consistent supervision of alternative fund managers. This has provided reassurance for investors and created a credible regulatory framework. An industry representative concurred that AIFMD has created an effective internal market for EU AIFs by providing a stringent framework and a comprehensive set of rules, which has led to increased harmonisation. Any changes to the Directive should be focused. During the severe market disruptions in March 2020, AIFMD demonstrated its ability to protect investors through the standards on liquidity and risk management. A regulator agreed with the previous speakers that AIFMD has allowed the development of a well-functioning internal market for AIFs with robust and internationally recognised standards. There is no need to 'break what is working well', but the opportunity to improve the framework should not be missed, since it is the first time that AIFMD is being reviewed. The review is in particular an opportunity to rethink its set up and improve its effectiveness with a streamlined single rulebook clarifying what is applicable for European asset managers, since many rules were introduced at different times.

An industry speaker acknowledged the need for a gradual improvement of AIFMD, but emphasized the importance of also taking into account the present macroeconomic environment. The amount of fiscal stimulus undertaken by the United States and the comparative speed of recovery in the US and many parts of Asia versus Europe illustrate the considerable amount of private capital that is needed to fund the post-Covid recovery. Banks or governments alone will not provide the financing that Europe needs over the next decade. Some non-European market participants also still consider Europe to be a relatively unattractive distribution destination for funds compared to the US or many Asian countries due to issues around reporting, the lack of a truly integrated single market, and the fact that investor education is generally lower in Europe than in other international markets. The industry speaker thus considered that the review of AIFMD should not be 'too-gradual' as there is a risk of missing some opportunities in terms of access to capital.

1.2 Main focus of the AIFMD review

A policy-maker mentioned that the Commission has identified several areas for improvement. First, there is fragmentation around depository services. The idea of a passport for depositories is an old debate that the Commission has previously sought to introduce. In the past, a consensus has been difficult to find, nonetheless, further integration would certainly improve the operation of the market. Secondly, improvements in reporting are being considered since they would offer supervisors better tools and better data. The Commission is also assessing whether loan origination funds, which are developing very quickly, deserve specific rules. The Commission will moreover evaluate whether liquidity management tools, which are implemented very differently across member states need further harmonisation. Finally level playing field issues will be considered in order to establish whether different financial intermediaries are subject to the same obligations.

A regulator emphasized the other areas of focus for the AIFMD review from the perspective of ESMA. First, there should be greater regulatory harmonisation between the AIFMD and UCITS frameworks. In some areas AIFMD is more advanced and granular than UCITS. This includes risk management and also reporting, where there is an elaborate reporting mechanism for AIFs but not for UCITS funds. The second area of improvement for ESMA is liquidity management tools. It is important to ensure that these tools are available consistently across member states and to the various regulators, as shown by the recent market stress in March-April 2020. Swing pricing, gates and side pockets must be tools available throughout the EU. ESMA's third and somewhat controversial priority concerns delegation. While delegation arrangements can increase efficiencies and ensure access to external expertise, given the global nature of the investment fund industry, its extensive use may also create operational and supervisory risks, particularly in relation to empty shells and letterbox companies. While AIFMD already provides some requirements on delegation, this issue needs to be re-evaluated in ESMA's view.

Another regulator agreed with the areas of improvement identified and the need for further harmonisation. The reporting requirements in AIFMD – i.e. concerning data collection, the information made available to the authorities and the delays for providing the information - can be improved, and these improvements should be extended to UCITS. A more consistent framework should be developed for liquidity management tools across the EU with guidance on how to use them in order to facilitate access to these tools for asset managers.

1.3 Possible areas of improvement of the AIFMD Directive

Delegation arrangements

Several panellists emphasized the importance of delegation for investment funds and the need for possible changes to existing AIFMD rules in this area to be clearly focused. A regulator stated that delegation in fund structures contributes to the efficiency of the fund. It is important to remember, when considering a review of delegation and substance rules, that this topic emerged during the Brexit process. There were concerns about delegation in this specific context, but these were not driven by supervisory issues relating to AIFs in general. The regulator suggested that improvements to the delegation system should therefore be targeted and focus on specific issues such as control measures at manager level. For example, the ESMA Brexit opinion emphasizes the importance of due diligence when choosing delegates and how it should be conducted. It is also essential to ensure good governance and adequate staffing at manager level both in terms of resources and competences and this is important in all cases with or without delegation. The regulator stressed that purely quantitative criteria should be avoided when determining whether there is an adequate level of delegation. For example, ESMA's letter to the Commission referenced high amounts of fees paid to delegates as an indicator of excessive delegation, which is not an appropriate criterion in many cases. What is needed instead is ensuring that there is an effective control mechanism and appropriate governance in place.

Another regulator agreed with the proposals made by ESMA in its letter to the Commission regarding delegation and suggested that the strong delegation framework in AIFMD could be extended to UCITS. The concept of a letterbox entity exists in the UCITS framework, but there has been no development of this concept in the same way as in AIFMD (e.g. with a definition of what delegation means, how supervisors should consider these issues and what kinds of controls and tools should be implemented). Additionally, the work which was completed in the context of Brexit regarding delegation could be used to complement the UCITS framework. The regulator also encouraged the Commission to analyse some of the recently developed delegation frameworks that are used to evaluate the extent of delegation and whether managers maintain appropriate control of key functions.

Retail investor access to AIFs

Answering a question from the Chair about the possible need to make AIFs more accessible to retail investors, an industry representative suggested that while making more products available to retail investors makes sense in general, this does not seem appropriate in the case of AIFs. UCITS already offers a wide suite of investment opportunities for retail investors and has the advantage of being a structure widely recognised in the market that provides appropriate safeguards for retail investors. The particularities of AIFs also need to be taken into account. If AIF products were developed for retail investors, it would be necessary to define appropriate risk limits, considering their expectations in terms of liquidity and investment time horizon, which would be different from those used for professional investors. That would dilute the current AIFMD model which works well. Distributors would also have to provide retail investors with more information on the characteristics of funds and conduct more comprehensive due diligence and suitability testing, which could add complexity to the existing distribution model. The industry representative therefore suggested that there are more appropriate alternatives to opening up AIFs to retail investors, such as making changes to the ELTIF framework, which seems a more suitable vehicle for retail investors. Another alternative could be to broaden the definition of professional investors under MiFID in order to include more sophisticated retail investors.

On the question of increasing retail participation in AIFs, a regulator agreed that it would be preferable to target retail investors with an adjusted ELTIF product rather than with an adjusted AIFMD product.

Depositary activities and supervisory fragmentation

A regulator stated that the introduction of depositary passports could increase supervisory complexity, creating a scenario where there could potentially be a manager in one jurisdiction, a fund in a second jurisdiction and a depositary in a third jurisdiction. The duties of the depositary, especially concerning oversight, make it the external entity which is closest to the day to day functioning of the fund. Implementing the depositary passport would make the work of supervisors more complex and complicate information flows between different actors in the value chain. The regulator considered it preferable to develop technical solutions which would allow depositories based outside the AIF domicile to be licensed to provide depository services in the home jurisdiction of the fund. Initially AIFMD had the 'Maltese exception', which expired in 2017[1]. This could be a technical way to address the issue of depositary fragmentation without questioning the fundamental rule that, where possible, the depositary should be established in the same jurisdiction as the AIF.

Another regulator was not favourable either to a depositary passport and agreed that improving the current framework is a better option. For example, the segregation requirements that ESMA worked on for depositary functions could be included in the legislation. The regulator concurred with the previous speaker that supervisory fragmentation may be a concern in the context of AIFMD with a fund, a management company and a depositary all potentially located in different jurisdictions with different supervisors. This multiplicity of supervisors creates potential complexity around supervisory interactions if there is a need to intervene, even if day-to-day cooperation works well. This issue needs addressing in the AIFMD review. The system does not need to be entirely changed, however. Rather, it would be preferable to improve coordination with one authority playing a lead supervisory role. This authority could have an oversight role for all EU activities of a given operator for example, which would improve the effectiveness of supervision.

2. On-going review of the ELTIF framework

2.1 ELTIFs have experienced a limited uptake

A regulator mentioned that the ELTIF regime aims to increase long term investment in Europe's real economy, but only a small number of ELTIFs have been launched so far with a relatively small amount of net assets under management. ESMA's register indicates that there are 27 active ELTIFs in Europe, and 16 of them are domiciled in France, which cannot be considered as a success.

A regulator agreed that ELTIFs have not met with the success hoped for by the co legislators. Indeed, very few ELTIF funds have been launched so far. Even in France, in absolute terms the amount of assets within ELTIFs only amounts to €1 billion. A potential explanation for France could be the culture of private equity and infrastructure investment. The relatively poor performance of ELTIFs overall could be related to tax incentives, regulatory requirements or a lack of harmonisation in regional marketing rules. These avenues to explore were highlighted in the CMU High Level Forum report. A second regulator noted that often projects for launching ELTIFs do not go to the end and agreed that the lack of an attractive tax regime could be one factor that affects whether or not an asset manager ultimately decides to launch an ELTIF fund.

A policy-maker stated that the Commission is confident in its ability to improve the uptake of ELTIFs, which need more time to impose themselves in the market. The Commission believes that ELTIFs can materially contribute to several very important EU objectives and priorities: the CMU, the European Green Deal and Energy Union. Increasing long term investment represents an essential step towards these major priorities.

2.2 Recalibrating ELTIF products and their investor target

A regulator stated that an instrument is needed to channel the large amount of savings that has been accumulated in Europe, towards long term investments and equity financing. ELTIFs may not be the full solution but should be part of it. The ELTIF review is an opportunity to reassess how these funds can respond better to investors' needs and to the challenges facing CMU. It is possible that ELTIF seeks to address too many investors at the same time. The fact that it is both a professional and a retail product makes it very challenging because different investor types have different needs: some of the long term characteristics of ELTIF are not well suited for retail investors for example and vice-versa. In addition ELTIFs are in competition with domestic AIF products that tend to be more focused on professional investors. The added value of ELTIFs compared to these domestic products should be more clearly defined. There could be ELTIFs targeted at professional investors with more relaxed rules regarding diversification, concentration limits and leverage limits and others addressing retail needs with the necessary protections and safeguards concerning suitable advice and information.

The regulator emphasized that for retail investors the key point is liquidity management because retail investors are culturally risk averse and they tend to demand more access to liquidity. There is a need however to reconcile this need for liquidity with the long term nature of the ELTIF product. ELTIF should remain a closed ended structure in order to avoid a liquidity mismatch which would not function with very long term investment assets on the asset side. However, these funds could be traded on trading venues to provide some form of liquidity or have some kind of liquidity windows in a secondary market.

An industry speaker considered that involving retail investors should be one of the priorities of the ELTIF review, because retail investment is an important source of capital, which Europe must tap into and agreed that liquidity is important for these investors. However, expanding the scope of eligible assets, which is the usual temptation when tackling this type of issue is not the right answer, because it would not achieve the initial goal of fostering long term

1. Prior to the transposition of AIFMD, hedge funds licensed in Malta were free to appoint a depositary situated in any reputable jurisdiction. AIFMD has restricted this freedom, in that the depositary is required to be situated in the jurisdiction where the AIF is established. Malta negotiated a temporary derogation from this requirement until July 2017 whereby depositaries of Maltese AIFs could be located in other EU Member States, provided that the appropriate supervision was conducted in the depositary's home country.

investment. Some definitions could be clarified and indirect investments such as securitisation could be added, but these are not core issues. The underlying issue with ELTIFs, the industry speaker stated, is that they are operated using technology from the last century, which has a major impact in terms of cost and liquidity. The cost of setting up an ELTIF and completing the legal paperwork is usually about 10 times more than a UCITS fund because a bilateral debt agreement is often over 100 pages of legal contracts and is very difficult to standardise. In this regard, there could be a role for blockchain technology, which could facilitate the provision of real time information on distribution, asset valuation and so on. This technology would facilitate the exchange of information across manufacturers and distributors and it could also be instrumental in creating a secondary market liquidity platform. It is indeed much better to have secondary market liquidity than to try to put liquidity into a fund which by definition is not liquid. The use of blockchain could help democratise these long-term assets.

A policy-maker observed that an expansion of the eligible assets does not necessarily contravene the goal of fostering long term investment. In fact, allowing managers more scope would allow them to better meet the demands of their clients while still preserving the essence of the ELTIF.

A regulator agreed that one of the core issues with ELTIFs is satisfying both professional and retail investors, but stressed that it is essential not to ‘throw the baby out with the bathwater’. The positive features of the ELTIF framework need preserving. It is important to ensure that these funds provide access to assets which are intrinsically less liquid, have less information and are riskier. For retail investors to be involved in ELTIFs, which is important from a CMU perspective, it is necessary to have the right safeguards in place, mainly in respect of liquidity and redemption. These funds should remain closed ended and therefore other ways of enabling liquidity should be proposed. ESMA made several proposals for improving ELTIFs in this regard. While the regulator acknowledged that the scope of assets should not be entirely reconsidered, ESMA suggests that there should be some assessment of whether the current rules are too restrictive and whether ELTIFs can have a wider scope from a funding perspective.

Answering a question from the Chair about the importance of financial literacy for developing retail investment in ELTIFs, an industry representative considered that financial literacy is certainly an important factor, but there is a range of issues to address that were appropriately highlighted by the previous speakers. No single measure will address all of the issues raised by ELTIFs, therefore the review must make a combined and holistic consideration of the different issues at stake, including the functioning of the product and using new technologies, as was previously suggested. A regulator mentioned that the suitability test in article 27 of the ELTIF regulation, which applies when a fund is accessible to retail investors could be reviewed. Having protective measures is necessary, but promoters of these funds consider this test to be very cumbersome, as it applies on top of retail fund marketing rules. A policy-maker stated that the Commission is reviewing ELTIF carefully, considering all the aspects mentioned by the panellists, in particular how to achieve a better targeting of ELTIF funds for each type of investor.

Conclusion

The Chair summarised the debate, noting that long term investment is necessary for infrastructure and for securing citizens’ retirement and also for the post-Covid recovery. All of the panellists had agreed that AIFMD is a success, and any changes to it should be targeted adjustments. On ELTIFs, the panellists had agreed that the review is an opportunity to rethink the framework and purpose of the regulation.