ELTIF / AIFMD REVIEWS

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Regulatory push for collective investment: a much needed review

The proposals to modify the AIFMD and the ELTIF Regulation pursue quite different objectives. The first aims at improving the liquidity management and the supervision of AIFs and, more importantly, UCITS. The second incorporates some positive changes to stimulate the way that collective investment can contribute to CMU objectives. These reforms boost collective investment as an effective and safe way to attract more retail investors to capital markets.

Regarding AIFMD and UCITS there are two hugely important modifications. The first is the introduction of liquidity management tools, since they step up the requirements for an adequate and effective liquidity management. We at CNMV welcome this, since we have long advocated for reinforcing the requirements linked to liquidity management and we have been very active in their supervision, mainly in periods of stress such as those experienced in 2020. This should also soothe some concerns about possible systemic risks: investment funds will be even better regulated and supervised after these reforms become effective.

The second change worth mentioning is the modification of the reporting regime to NCAs, since the previous regime did not include the detail of positions in the portfolio, which reduced its usefulness. Speaking from a jurisdiction (Spain) that requires since 1990 monthly reporting of detailed ISIN-level positions at individual fund level, I can assure that this is an immensely useful tool for supervision with very low ongoing costs for management companies once the systems are built. I hope the granularity and frequency are sufficient to enable proper monitoring and supervision.

These reforms boost collective investment as a way to attract more retail investors to markets.

A third positive element is the planned modifications in the loan funds with the aim of supporting the CMU strategy. However, in this case, I have the feeling that the proposal is too flexible in two main issues. On the one hand, the alternative funds are not prevented from granting individual loans to retail clients - there is just a 20% diversification limit when lending to financial entities or collective investment vehicles –. This, in itself, does not create a significant risk, but I doubt that direct retail loan activity by AIFs is meant to mean any substantial difference in terms of availability of credit. On the other hand, the fund is expected to be closed only when the amount of loans exceeds 60% of the assets managed. This figure may be too high for an adequate and effective management liquidity policy, in order to ensure reimbursements and equal treatment between investors.

The proposal does not include some more technical elements that were mentioned in the ESMA letter to the European Commission, to clarify the application of the MiFID regulations. In the same level, a clarification of the rules applicable in the case of cross-border structures has been left out, especially on the respective responsibilities of home and host supervisors. This is an element with a high impact in some jurisdictions.

ELTIFs have so far failed to become a meaningful EU label. The amendments to the ELTIF regulation are deep and relevant, in line with the CMU's strategy, for which this vehicle is considered a relevant piece.

Beyond a set of positive technical and operational considerations that should make their operating regime more flexible - such as reduction in coefficients, a greater number of eligible assets and other modifications in the case of a vehicle focused on professional investors -, the Commission's proposal includes two key points, a priori suitable, but not exempt from uncertainties.

Firstly, the idea of a "secondary market" for ELTIF's "shares". This seems a laudable initiative, so that investors have an early way out. But the key will be to ensure that investors are aware that liquidity cannot be ensured, even with that mechanism. The Level 2 measures by ESMA to develop information requirements will be, in this sense, essential.

The second key point refers to the ambitious modification of the requirements for its commercialization, with the aim of spreading the investor base. The Commission approach is bold, with a triple removal: i) the minimum subscription amount (established at €10,000), ii) the limit of 10% of the investor's financial assets and the requirement of advice. The proposal keeps just the suitability test requirement and the (written) warning when the product's 10-year maturity is exceeded. I think that we should remain vigilant and strengthen information to investors to avoid that this important softening of the regime produces excessive concentration and liquidity risks on retail investor's portfolios.

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Evolution, not revolution is needed in the review of the AIFMD framework

The European Commission's package of measures to boost Europe's capital markets provides the potential to further develop our capital markets. This should boost the real economy and facilitate post COVID-19 growth. The AIFMD was originally adopted in 2011 in response to a crisis of a different nature, that of the global financial crisis that exposed weaknesses and vulnerabilities in certain fund activities. That led to a framework which ultimately sought to provide high-levels of investor protections while also facilitating EU AIF (Alternative Investment Fund) market integration, in tandem with a coherent supervisory approach to the activities of AIFs – still valid objective today.

The development and implementation of this framework was not without its challenges and therefore it was heartening that the European Commission ultimately concluded that it had largely achieved its original objectives. This conclusion was accompanied with the caveat that the AIFMD could benefit from targeted improvements and to take account of new developments in the market since 2011. Ireland has developed a vibrant fund and asset management industry over the last number of decades. We have significant policy and supervisory experience and bringing our experience can help this review process. In this regard, there are a number of key areas focusing attention right now.

Liquidity management tools can have a role to play in strengthening the EU framework. At present, the AIFMD does not provide for a minimum harmonised set of LMTs available to AIFMs that would enable fund managers in every Member State to adequately deal with pressures under stressed market conditions or in order to better handle potential cross-border spill-overs of liquidity tensions. A standardised approach across the EU would be sensible and the experiences of some member States in this regard should inform the debate. The ability to delegate functions to third parties allows the AIFM to benefit from cost savings, utilise expertise in specific markets and access global trading capabilities while being subject to strict control, oversight and accountability by those funds' national regulator in compliance with EU rules. This crucial element of the AIFMD framework has facilitated Fund Managers (AIFM) to fulfil their remit to serve investors in the AIFs that they manage and act in their best interests.

AIFMD brand can't be overstated, it's an integral aspect of the EU's global investment fund offering.

The Commission has rightfully acknowledged that the current delegation model as facilitated by AIFMD has worked well and remains one of the key pillars supporting the EU's cross-border investment model. The proposed changes to the delegation rules largely focus on minimum substance requirements and transparency in relation to delegation practices. During the course of negotiations it is crucial to ensure that any changes made, however slight, do not undermine the global funds model or contradict our agreed goal of deepening the EU Capital Markets Union. Provisions in the AIFMD surrounding the harmonisation of depositary liability and functions have been successful in enhancing investor protections. The Commission's proposal to allow for cross-border access to depositary services under strict parameters has the potential to be a pragmatic compromise but we must remain vigilant to the potential creation of additional risks. Loan origination by investment funds play a positive role in a well-diversified financial system, complementing bank based funding and supporting the real economy. In 2014 Ireland became the first EU country to introduce a specific regulatory framework for loan origination by investment funds. Recognising the importance of loan origination by funds the Commission has sought to introduce a degree of harmonisation to the regulation of this activity having regard to the fact that there are a myriad a national loan origination regimes, and none.

As a jurisdiction with a pre-existing domestic regime for loan-origination by AIFs, we are supportive of a harmonised approach which provides common legal framework to mitigate against the potential risks related to this type of activity.

The need for an effective framework, encompassing governance and risk management, is heightened by the potential role which loan-originating funds can play, within appropriately calibrated parameters, in the deepening of our Capital Markets Union. This function would allow these AIFs to play a larger role in supporting job creation, economic growth and contributing to the recovery from the Covid-19 pandemic; ultimately aligned with our shared objectives for the continued development of the Capital Markets Union.

Finally, unlike other vehicles such as the current version of ELTIF, the AIFMD has proven to be a European success story that continues to fulfil the stated objectives of providing robust investor protection and addressing systemic risks.

The importance of the AIFMD brand cannot be overstated and it is an integral aspect of the EU's global investment fund offering.

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AIFMD and ELTIF Reviews: how to boost contribution of asset managers to the EU?

As published in November 2021, the proposal by the European Commission (EC) to amend AIFM and ELTIF legislations has to be welcome.

Regarding AIFMD, and as promised, the EC only spotted a few targeted topics to be reviewed or introduced: Liquidity Management Tools (LMTs), Delegation, Supervisory Reporting, Loan-originating Funds, Depositary, Fee Disclosure. The EC was fully right in trying to avoid a comprehensive review of AIFMD, which would have broken a successful Directive to the detriment of investors and EU-based asset management companies. We think that this proposal is largely well calibrated on delegation and depositary in particular.

However, as usual, the European Parliament (EP) and the Council have a key role to play to improve further the initial draft proposal issued by the EC.
For LMTs, setting a list of tools to be made available in all Member States makes sense, to make sure that fund managers are equally equipped to manage any exceptional situation they might face regarding open-ended funds. But a crucial point to be amended is to be more specific on the scope of "technical details" to be provided at Level 2 by the EC and ESMA: as currently drafted, they would set for instance the conditions for "selection and use of suitable" LMTs by fund managers. In our view, the use of LMTs is by nature related to ad hoc circumstances, and otherwise we might end with 'strait-jackets' – e.g. defining market triggers – which would automatically generate Systemic Risks if all fund managers had to use the same LMT at the same moment due to a given market circumstance. Over-harmonization would unwittingly lead to Systemic Risk.

Regarding loan-originating funds, some provisions do not appear as rightly calibrated yet. For example, the 5% retention rule from the Securitization framework has been replicated here, but without any exemption. This is surprising – and potentially harmful – as in major Member States some legislations applicable for many years (e.g. in France since 2016) provide for an exhaustive list of fully justified limited exemptions: in case of liquidation of funds, in case of fund units held by a single investor, in case the purpose of the sale is to avoid a breach of the fund's investment rules, etc.

Over-harmonization would unwittingly lead to Systemic Risk.

On fund fee and charge disclosure, the provisions proposed by the EC in AFIMD review might create additional confusion, as we already have to comply with UCITS, PRIIPs and MiF in that matter. We would suggest keeping only the references to this three latter series of measures.

Regarding Supervisory Reporting, the proposal by the EC to increase it for UCITS funds at EU level has to be carefully assessed by the EP and Council before giving any narrowed mandate to ESMA on that topic: today, EU asset managers have already to report their fund inventories to the ECB and national central banks, line by line, and should not therefore end with new, additional reportings based on complex and costly calculations that our non-European competitors do not have to carry out and produce today. The first and key action is to ensure that the ECB and central banks share with ESMA and national securities regulators the data they already receive from us. From an EU competitiveness perspective, new reportings should not be added.

Last, regarding ELTIF review, we strongly support it. As everyone knows, it was not an EU success up to now. The point is not vis-à-vis professional investors: they usually ask for dedicated funds that we can easily build; so this type of investor should not be the priority of the review. The core progress to be made for ELTIF review is vis-à-vis retail investors, to allow them to finance European 'real economy' assets, such as infrastructures or SMEs: it would be a critical way for European institutions to make EU citizens feel closer to European enterprises and contributing to job creations and economic growth in the Single Market.

Various cases of successful domestic vehicles exist in Member States, such as the French 'Relance' evergreen funds ensuring national infrastructure and SME financing by true mass retail investors - with 80% of individual subscribed investments below 10 000 euros each. But to replicate such domestic successes at EU level, it implies amending further ELTIF rules towards retail investors: lower subscription threshold, more flexibility in investment, distribution rules and tests fully governed by MiFID to ensure a level playing field with other financial instruments.

Why not introducing such amendments, to bring at last EU citizens a concrete tool to become active builders of the Union projects?

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Targeted enhancements of the rules that build on the existing successful regime

The AIFMD and the UCITS Directive form the backbone of the regulatory framework for the asset management industry in Europe and have a long and successful track record, repeatedly tested through several stressed-market conditions. The current review is at the centre of the EC's plans for a stronger CMU in the service of the European economy, investors and consumers. To deliver on this goal, it is critical to build upon the successes and make adjustments that can enhance, but not jeopardise, the current high-quality standards and sound mechanisms, as these have allowed investor choice, product innovation and effective investor protection and management of risks.

Overall, the legislative Proposal published last year acknowledges these merits and aims to close certain gaps via specific adjustments. While further consideration may be necessary for some of the suggested actions, the overall principle of not reshaping a regime that is functioning properly constitutes a pragmatic approach and is the right course of action for the co-legislators.

One of the main areas addressed in the Proposal relates to delegation arrangements. As a global leading asset manager of actively-managed equity and fixed income strategies offered to investors around the world, Capital Group has deep experience with delegation, how it ensures high quality results for investors and a truly competitive position for Europe, while remaining fully overseen by the EU supervised entity. Our mission is to give our investors equal access to the best, largest and most diversified team of portfolio experts we can assemble and via proprietary research on assets and industries that are located globally. This allows investors to benefit from a true cross-border ecosystem, while at the same time maximises our ability to engage with portfolio companies locally as the most effective possible steward.

The principle of not reshaping a properly functioning regime is the right course of action.

Currently, AIMFD rules ensure outreach to the right expertise, and are balanced with appropriate investor protection, oversight and accountability safeguards. The EC acknowledges this and aims to make limited additions relating mostly to gathering information and strengthening proper supervision on how control and oversight are performed. Although it is our experience that this reporting is largely already taking place among asset managers and supervisors at the national level, we understand that further coordinating the flow of the information among regulators remains important for investor and regulator confidence. At the same time, the approach taken should avoid a counter-effective debate as to how much is or should be delegated. Instead, it should focus on addressing remaining information gaps – without duplicating - and importantly, aim to protect the level and quality of expertise necessary for appropriate management. This is the only approach that can ensure best investor outcomes.

Another key area of the Proposal relates to liquidity risk management. We share regulators' need to understand what went wrong with the market volatility of 2020 and draw the right lessons as to risk prevention in the future. From the perspective of open-ended funds in Europe, one key observation is that amid this "real-life liquidity stress test" only a limited number of funds suspended redemptions while the vast majority were able to maintain their portfolio structure. Here, the AIFMD framework showed its merits: via requiring liquidity risk management processes based on the portfolio composition and liquidity characteristics. It ensured the sector was equipped with tools properly calibrated to market conditions and liquidity demands and remained resilient to market pressures.

Reinforcement proposals include ensuring the full list of liquidity management tools is at the disposal of asset managers in every jurisdiction. We fully agree, as this will further enable funds' readiness and resilience. In addition, strengthening supervisory convergence on that front can be helpful, keeping in mind that proximity and understanding of local characteristics is crucial, as is the role of national competent authorities.

Where we would draw attention is with the suggestion to allow regulators to step in at the individual fund level and trigger liquidity tools. We firmly believe that risk management requires in-depth understanding of the assets, liquidity profile and strategy employed by each fund and therefore asset managers are best placed to reach such decisions and properly report to their supervisors.

While we understand the need for a level playing field and legal consistency, it is important to also remember the differences between the two frameworks. UCITS is a product regulation focused on specific retail-oriented collective investment vehicles, while AIFMD is a framework for management companies that captures a heterogeneous population of funds targeting, to a large extent, professional investors. As such, different approaches and distinct requirements may apply and be appropriate.