AIFMD / ELTIF reviews: are the proposals up to the challenges of the CMU?

1. European long-term investment funds (ELTIF) regulation review

1.1 Current level of development of the ELTIF market and improvement objectives

The success of the ELTIF framework aiming to channel long-term financing to small and medium-sized enterprises (SMEs) and infrastructure projects has so far been limited. A regulator highlighted ESMA's June 2020 survey which indicated that almost five years after the implementation of the ELTIF regulation there are only 17 ELTIFs actively marketed in the EU. The majority of those are based in only four countries: France, Luxembourg, Spain and Italy. There has been a slight uptick over the last couple of years, particularly due to some local fiscal incentives, especially in Italy, but the market remains limited.

The regulator emphasised the need to look at what can be changed in the framework to make ELTIFs a more significant instrument for the financing in the European economy and a more attractive investment for retail and professional investors. Retail clients going into these instruments need to be adequately protected against potential liquidity and maturity issues. However, sufficient flexibility should also be provided in the framework to ensure that ELTIFs can invest in a wide enough range of assets consistent with the long-term investment aim. An industry representative fully supported the strategic importance of a vehicle facilitating infrastructure investment in particular and benefitting from a European passport, given the importance of infrastructures for the European economy.

An industry representative was favourable to developing ELTIF funds in the retail space, which is one key objective of the ELTIF review. This will support the financing of SMEs and infrastructure projects and also engage European citizens more in the development of the European economy. In France some domestic alternative investment funds (AIFs) investing in infrastructure or SMEs launched in 2021 have been quite successful in the retail market. More than 80% of the investments were made by mass retail investors with tickets below €10,000, showing the potential of such funds. But currently, such AIFs do not benefit from a European passport, which limits their development potential.

An official stated that ELTIFs are an important part of the Capital Markets Union (CMU). The objectives of fostering longer-term investment and providing capital to the real economy should not be forgotten in the technical discussions about the legislative proposal. However, there is much work to do, when considering the present level of development of the ELTIF market. Bringing retail savers into this framework will provide such investors with new investment opportunities while at the same time providing the EU economy with additional sources of capital. That said, involving retail investors will require a focus on investor protection and this may require trade-offs. Building trust and confidence among retail investors will be needed, in addition to improving financial literacy. These are part of the key objectives of the Capital Markets Union (CMU).

A public representative agreed about the importance of improving financial education in Europe. For capital markets to function appropriately, it is necessary to provide investors with the right information, but they also need to have the capacity to understand and use that information in their investment decisions.

1.2 Regulatory changes proposed

The Chair noted that ESMA had sent a letter to the Commission at the beginning of 2021 with recommendations on how to review the ELTIF regime covering areas such as eligible assets, the authorisation process, portfolio composition, redemptions and disclosures. A regulator stated that ESMA is in favour of the proposals made for reviewing the ELTIF framework. It has to be ensured however that more retail investor participation is accompanied by the right level of protection.

An official considered that the provisions proposed by the Commission for developing retail investment in ELTIFs, such as the lowering of the entry threshold, as well as the proposals for facilitating the administrative management of these funds and reducing compliance costs are heading in the right direction. However their impact will need to be evaluated and it should be ensured that they do not undermine investor protection. There is a fine line to walk there.

An industry representative agreed that many tricky issues with ELTIFs are being tackled in the review proposal, including the possible opening of these funds to retail investors and related liquidity issues, and also how the burden and costs of managing these funds can be alleviated for asset managers. Another industry representative added that the ELTIF review proposal is addressing many issues that were obstacles to the launch of ELTIFs in the initial framework. These include the widening of the eligible assets on the real estate and infrastructure side and the reduction of the minimum investment threshold for retail investors.

The Chair noted that finding the right balance in terms of liquidity rules is an important issue, because retail investors must not have the impression that ELTIFs can be redeemed at any moment. A regulator agreed that liquidity provisions are instrumental in defining the way that these funds can be used by retail investors. Level 2 empowerment on the matching mechanism will allow a fine-tuning of these rules.

2. Alternative Investment Fund Managers Directive (AIFMD) and UCITS Review

2.1 Overall objectives of the AIFMD review and challenges to overcome

The Chair pointed out that, in fact, this reform was much more than an AIFMD reform, since it touched also on a number of important UCITS provisions. The panellists were generally supportive of the proposal made by the Commission to amend the AIFMD directive. An industry representative remarked that the existing AIFMD and UCITS frameworks have largely contributed to creating two major investment fund markets, which are among the most successful ones in the world. This success is due to the frameworks striking the right balance between investor protection and innovation, allowing the development of products corresponding to the main needs of investors. The AIFMD framework also proved its solidity during the 2008 financial crisis and the Covid crisis. It is important in this review exercise to not try to rebuild what has proven to be solid. Adjustments should be focused on areas that have evidenced problematic weaknesses or gaps.

An official noted that AIFMD has developed into a global brand and agreed that a major overhaul of the directive is not desirable. It is founded on a very successful passporting regime balancing financial innovation and expertise with the safeguards of investor protection and financial stability. What is being considered in the AIFMD review is evolution rather than revolution, which is the right way forward. Though there are points of concern which have to be addressed to ensure there are no vectors of instability, it should not be forgotten that the guard rails of AIFMD have worked so far including during the Covid crisis, which was an unforeseen extreme period of stress for the overall economy.

A public representative emphasized that AIFMD is a key element of the wider CMU strategy aiming to facilitate investment in EU businesses as well as provide attractive investment opportunities. The European Parliament is in the process of listening to different stakeholders in order to identify what changes are potentially needed in the AIFMD to enhance the legislation. A calendar has now been approved for the review with an objective to schedule the final plenary vote on the AIFMD review report in the first or second session of October in order to finalize the revision as soon as possible.

Agreeing with the previous panellists, the public representative suggested that while a revision is needed, the benefits and strong points of the current legislation must be preserved. The aim is to have the right balance between enhancing the competitiveness of the EU fund market and investor protection. The proposal for the review of AIFMD is moving in the right direction in this regard. The ambition is for the EU to become the first market for funds at the global level over time. Supervision is a further issue to be tackled for supporting the development of the EU fund market and more broadly the CMU, because at present it works in a fragmented way across jurisdictions and financial sectors in Europe. There is a need for a real European supervisory authority equipped with appropriate tools to conduct supervision across the EU in connection with the national competent authorities (NCAs).

A regulator noted that supervisory convergence actions such as peer reviews are already conducted on a regular basis in order to achieve common supervisory outcomes. There have been suggestions that the frequency of peer reviews should be increased and more clearly mandated in Level 1, but the intensity of supervisory convergence and the convergence tool used should primarily depend on the potential risks and the desired outcome.

2.2 Delegation arrangements

An industry representative noted that delegation is an important aspect of the AIFMD directive and has proven its added value, allowing an optimisation of portfolio management activities in particular. The aim is to give investors the best possible product. The current delegation framework also proved its resilience during the recent market turmoil and is a solid basis. There should not be a distinctive treatment between delegations inside the EU and delegations outside of the EU, because the responsibility in the two cases remains with the management company based in the EU. In addition one idea, which could be preferable, could be to task ESMA with carrying out a common supervisory activity on delegation to determine if all the delegation arrangements put in place by a given management company are working adequately.

A regulator noted that delegation remains a controversial topic. Rules were put in place in the Brexit context to avoid empty shells and clarify responsibilities, but there is no intention of forbidding delegation. The new proposals made in this area are important for achieving further supervisory convergence and collecting the data and information needed for ensuring a more effective oversight of market practices and risks. It may be helpful also to have a common view on the breakdown of activities included in the portfolio management function in order to facilitate the assessment of delegation arrangements by the NCAs.

A public representative stated that the proposals made on delegation are on the right path. Funds need to be profitable, which includes allowing delegation so that portfolio management activities can be organised in an optimal way. However, access to information and investor protection must be preserved in a context of delegation. An official suggested that improved financial literacy and investor trust and confidence would facilitate the tackling of issues such as delegation and the location of asset management activities, along with the use of liquidity management tools (LMT).

2.3 Liquidity management tools (LMTs)

An industry representative considered that the proposal to provide a minimum set of LMTs at the Level 1 of AIFMD is an improvement. There is too much diversity across member states at present and some of them do not allow a sufficient use of LMTs. However, caution is needed regarding the mandates given to ESMA in this context. In the current drafting, the proposed Level 1 indicates that

ESMA should define the conditions for using LMTs. While the intention of defining ex ante the way that LMTs may be activated, is understandable, the risk is that there ends up being very specific conditions for using LMTs. Flexibility is needed in this regard. The use of LMTs should remain in the hands of the asset managers. In the most exceptional circumstances regulators may also have the power to activate some tools such as suspensions and gates, but for swing pricing, for instance, it would not make sense.

A second industry representative agreed on the need for flexibility and approved of the starting point regarding LMTs in the AIFMD review proposal, notably the fact that LMTs will be available in all EU member states in the future. Ultimately, the decision to trigger the LMTs should be with the management company, under the close supervision of the NCAs, one of the main reasons being that the appropriate tools to use may vary from one fund to another.

An official was also supportive of the proposals concerning LMTs. A number of member states would agree with the responsibility for the deployment of LMTs being with the fund manager and limiting the powers of NCAs to very exceptional circumstances. However, some member states have no experience of these tools and need to gain some understanding of their functioning.

A regulator agreed about the importance of clarifying the use of LMTs further and appreciated the sensitivity and possible concerns around NCAs being involved in the activation or deactivation of those tools. ESMA is indeed tasked with establishing the conditions under which NCAs could request managers to use these tools. The first-line obligation needs to be on the managers. The question is whether an NCA should have a 'stick', which hopefully it will never use, to be able to ultimately force the use of these tools and if so in which circumstances.

The Chair noted that CNMV, the Spanish supervisor, published recently a new set of technical guidelines on LMTs that are broadly consistent with the comments made by the panellists. The responsibility for activating LMTs lies with the manager but there are procedures defining how the fund should react to certain stress situations and the 'stick' will remain in the hands of the NCA in extreme cases where the fund manager would not take appropriate action.

2.4 Reporting requirements

An industry representative suggested that reporting requirements could be streamlined. For UCITS, fund inventories are reported in a very granular way (i.e. line by line, asset by asset, for each fund) to the national central banks of the jurisdictions where the funds are domiciled, particularly for France and Luxembourg. However, this data is not shared by central banks with their local securities regulators, leading to potential duplications. The sharing of reporting data provided among the authorities should be requested in Level 1. An official agreed that reporting should be conducted in a way that does not over-burden the fund industry with duplication or inconsistencies. There is a need to be smart and streamlined in this regard and ensure that the data flows across the different authorities.

A regulator was thankful for the closing of the reporting gap on UCITS. There has been AIFMD reporting for a long time, but this was not the case for the UCITS market. ESMA is very supportive of achieving integrated reporting and aligning reporting requirements. The most needs to be made out collectively of the reporting, which means that it needs to be properly channelled to the authorities who need to work on the data and shared among them, rather than setting up separate reporting requirements. One area where information to supervisors remains insufficient is transaction reporting for market abuse monitoring purposes.

A public representative noted that the Parliament is generally in favour of increasing transparency, improving the access of supervisors to information and data sharing. The key is to find the right balance and to propose the right procedure for providing the information and sharing it in an effective way and also to define what type of information needs to be constantly available. This is currently being assessed and is likely to be one of the most controversial topics in the negotiation on the AIFMD review.

The Chair mentioned that Spain has had monthly reporting of line-by-line ISIN level positions since 1990, which is a primary source of information for CNMV's supervision. For instance, on 14 March 2020 with the Covid crisis and the biggest plunge in the stock markets in recent history for Spain, it would not have been possible to identify quickly enough which management companies were experiencing problems without these end-of-month reports. This detailed monthly reporting will also allow a review on the ESG features of funds compared to what they actually invest in for instance.

2.5 Loan origination funds

An industry representative stated that concerning loan-origination funds some aspects need considering in the fine-tuning of the Level 1 of AIFMD. For example, there is a 5% retention obligation in the current proposal. The underlying aim is to ensure that managers have some 'skin in the game' and do not put all the risk on investors, but this rule should be softened, the speaker felt, either with exemptions in some specific cases or being applicable only during a limited holding period.

An official agreed that common guidance and participation should be sought on loan origination funds. ESMA could be turned to for enhancing supervisory convergence in this area and identifying best practices.