

ESMA SEEKS TO SHAPE AIFMD2

Asset managers across the EU have been aware of the possibility of "AIFMD2" for some time, and have been watching carefully for signs of what changes it would bring to the current AIFMD framework. In this briefing we review ESMA's recent indications of its desired areas of change.

On 18 August 2020, the European Securities and Markets Authority (ESMA) published a **letter** outlining the areas in which, in its view, amendments to the AIFMD should be considered (the Letter). The areas in question are wide-ranging and significant, in some instances extending beyond the AIFMD to include changes to other regimes such as the UCITS Directive. Whilst the European Commission's proposed amendments to the AIFMD may in due course differ from those recommended by ESMA, the Letter provides a clear indication of areas in which amendments may be made.

Background

- Article 69 of the AIFMD requires the European Commission to commence a review on the application and scope of the AIFMD by 22 July 2017. As a result, the European Commission commissioned an independent review of the AIFMD, published on 10 January 2019 (**see our earlier briefing**), and completed its own review of the AIFMD, published on 10 June 2020 (**see our earlier briefing**).
- In addition, Article 69 of the AIFMD requires the European Commission to make proposals for amendments to the AIFMD, if appropriate. Thus far the European Commission has merely stated that it is assessing whether to propose amendments to the AIFMD. It is expected to make any such proposals in 2021, following a consultation period. The Letter sets out ESMA's views on the key areas in which amendments should be considered.

The Letter

The Letter sets out 19 areas in which, in ESMA's view, the European Commission should consider making amendments. A summary of each of the 19 areas is set out in Table 1. Key recommendations include:

- recommending **greater harmonisation between the AIFMD and UCITS Directive**. These proposed changes would involve amendments not just to the AIFMD but also potentially to the UCITS regime. While those managers who manage both AIFs and UCITS may welcome greater harmonisation, this may represent an unwelcome additional regulatory change project for those managers who manage solely UCITS;
- a series of recommendations on **delegation and secondment arrangements** – informed by recent Brexit-related manager re-organisations. These include

Key issues

- The European Commission is currently considering whether to make amendments to the AIFMD to form the so-called AIFMD2.
- In this context, ESMA has published a letter to the European Commission outlining areas in which, in ESMA's view, improvements to the AIFMD could be made.
- The improvements suggested by ESMA have the potential to result in key differences for firms between the AIFMD and AIFMD2 and to result in amendments to the UCITS Directive.
- They include suggestions for greater harmonisation between the AIFMD and UCITS Directive, clarifications regarding the permissibility of and rules relating to delegation by AIFMs and the use of secondment arrangements, greater clarity on the rules for reverse solicitation, the introduction of a framework for loan origination by AIFs and amendments regarding leverage reporting for private equity funds.
- Firms must now await further communications from the European Commission to see whether, and how, these suggestions may be implemented.
- It is currently expected that the European Commission will issue a consultation on the AIFMD in Q3 2020.
- Proposals for legislative amendments, if made, would be expected to follow in mid-2021.

recommending: the introduction of a limit on the maximum amount of delegation permissible; legislative clarification on whether extensive secondment arrangements comply with the substance and delegation rules in the AIFMD and UCITS frameworks; and supervisory convergence on which ‘supporting tasks’ performed by group entities are subject to the AIFMD and UCITS delegation rules. If such changes are introduced, managers may need to revisit (and revise) their Brexit structuring, which is likely to be an unwelcome cost in the context of the time and resource already expended on Brexit preparedness;

- in what may be a disappointment to many managers, recommending that **passporting should continue to be allowed in relation to marketing to professional investors only** (and not recommending the introduction of an ability to passport marketing to a category of ‘semi-professional investors’);
- recommending greater **clarity on the definition of, and rules for, reverse solicitation**. While greater clarity and harmonisation between EU member states on this issue is likely to simplify fund-raising, it also poses the risk of a ‘levelling up’ of requirements, whereby those jurisdictions which currently enjoy a relatively permissive approach towards reverse solicitation are ‘levelled up’ to the more restrictive interpretations of reverse solicitation applicable in other jurisdictions. The issue of levelling up was seen in the recent amendment to the AIFMD cross-border marketing provisions¹, which created a harmonised pre-marketing regime that is, in some jurisdictions, more restrictive than the pre-existing regime;
- recommending the **introduction of a framework for loan origination** within the AIFMD. This may increase the regulatory obligations applicable to those AIFs that currently utilise the relatively light-touch lending regimes applicable to non-bank lending in certain jurisdictions; and
- recommending the **removal of current wording in the AIFMD which states that private equity funds do not need to report leverage at the level of the structure in which they invest**². The result is that private equity firms may need to include leverage at the level of their acquisition vehicles, holding companies and operating companies in their leverage reporting (and, potentially, in relation to other leverage provisions in the AIFMD), notwithstanding the fact that the relevant lenders may not, and usually do not, have recourse to the private equity fund, its managers and its investors in respect of that leverage. ESMA states that the rationale for this recommendation is that the current exclusion of leverage below the level of the fund vehicle in private equity structures causes leverage in private equity to be under-reported. However managers may be concerned that the attribution of this leverage to the fund would present an inaccurate impression of the leverage risk to which the fund, its managers and its investors are exposed; and
- recommending that the European Commission **studies the benefits and risks of the introduction of a depositary passport**. The introduction of a depositary passport would represent a fundamental change to the depositary market and may

“In what may be a disappointment to many managers, ESMA recommends that passporting should continue to be allowed in relation to marketing to professional investors only”

¹ Directive (EU) 2019/1160

² This wording is contained in Recital 78 of the AIFMD

well be welcomed by managers if it results in greater competitiveness in the market for depositary services.

Next steps

- It is currently expected that the European Commission will issue a consultation on the AIFMD in Q3 2020. Proposals for legislative amendments, if made, would be expected to follow in mid-2021.
- As the UK has left the EU, it will not be obliged to follow any European Commission proposals for amendments to the EU AIFMD regime (subject to any agreement to the contrary with the EU). However, UK firms may be affected by amendments to the EU AIFMD regime such as changes to the provisions for marketing within the EU by non-EU AIFMs. In addition, the UK is likely to watch the European Commission's proposals closely and to consider whether similar proposals should be made to the UK's AIFMD framework. No firm statement on this point has been made in the UK. The Chancellor's Financial Services Update of 23 June 2020 did not refer to any immediately-proposed amendments to the AIFMD framework.

“While greater clarity and harmonisation between EU member states on reverse solicitation is likely to simplify fund-raising, it also poses the risk of a ‘levelling up’ of requirements’..... to the more restrictive interpretations”

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Table 1: Summary of ESMA's 19 areas in which amendments to the AIFMD should be considered

1.	<p>Harmonisation of the AIFMD and UCITS regimes</p> <ul style="list-style-type: none"> ESMA advocates greater harmonisation between the AIFMD and UCITS regimes. It notes, by way of example, that AIFMD Level 2 contains detailed requirements relating to risk management, liquidity management and delegation that are not contained in the UCITS framework.
2.	<p>Harmonised reporting for UCITS</p> <ul style="list-style-type: none"> ESMA advocates improving AIFMD Annex IV reporting and subsequently harmonising UCITS reporting requirements with the improved AIFMD reporting regime (while allowing for tailoring to reflect the specific characteristics of UCITS funds).
3.	<p>Scope of additional MiFID services and application of rules</p> <ul style="list-style-type: none"> ESMA notes that EU member states have divergent views on whether AIFMs and UCITS management companies may perform business activities other than those specifically listed in Article 6(4) of the AIFMD and Article 6(3) of the UCITS Directive. These articles set out the activities over and above AIFMD/UCITS activities that AIFMs/UCITS management companies may perform. In addition to recommending clarification of the above at an EU-level, ESMA recommends clarifying:- <ul style="list-style-type: none"> the extent to which MiFID, AIFMD and UCITS rules apply when AIFMs or UCITS management companies perform MiFID services; and which rules apply to delegates when investment management functions for AIFs and UCITS are delegated. <p>On these points there is, again, divergence between EU member states.</p>
4.	<p>Delegation and substance</p> <ul style="list-style-type: none"> ESMA notes that there is extensive delegation by some AIFMs and UCITS, and that delegation may also increase as a result of firms' Brexit structuring. Against this backdrop, ESMA recommends clarifying the maximum amount of delegation permissible, such as by specifying quantitative criteria or a list of core or critical functions that must always be performed by the AIFM or UCITS management company and that may not be delegated to third parties. ESMA recommends the introduction of legislation regarding secondment arrangements and states that it is questionable whether certain secondment arrangements are in line with the substance and delegation rules set out in the AIFMD and UCITS frameworks. ESMA recommends clarification over whether performance of certain tasks, such as legal and compliance roles, by entities other than the AIFM or UCITS management company is subject to the AIFMD's and UCITS Directive's delegation rules. ESMA recommends the introduction of specific regulatory provisions regarding "white-label service providers" (meaning fund managers that provide a platform as a service to business partners by setting up funds at the initiative of the latter and, typically, delegating investment management functions to those initiators. These are sometimes referred to as "AIFMs/UCITS Mancos for hire" or "host AIFMs/UCITS Mancos" in the UK).

5.	<p>Availability of additional liquidity management tools</p> <ul style="list-style-type: none"> ESMA recommends using the AIFMD review to ensure that all liquidity management tools outlined in Recommendation A of the European Systemic Risk Board's Recommendations on liquidity and leverage risks in investment funds (https://www.esrb.europa.eu/pub/pdf/recommendations/esrb.recommendation180214_ESRB_2017_6.en.pdf) are available in all member states. Recommendation A recommended (amongst other things) the introduction of EU legislation to create a common framework governing the inclusion of liquidity management tools in the design of investment funds. Liquidity management tools include suspensions of redemptions, gates, extendable notice periods, swing pricing and anti-dilution levies.
6.	<p>Leverage</p> <ul style="list-style-type: none"> ESMA recommends aligning the current reporting of the gross method of calculation of leverage under Article 7 of the AIFMR with the framework set out in the International Organisation of Securities Commissions Recommendations for a framework assessing leverage in investment funds (https://www.iosco.org/library/pubdocs/pdf/IOSCOPD645.pdf)
7.	<p>AIFMD reporting regime and data use</p> <ul style="list-style-type: none"> ESMA identifies a number of problems and proposed solutions to the AIFMD's reporting regime and data use. Proposed solutions include: <ul style="list-style-type: none"> requiring all AIFMs to acquire and report an LEI for themselves and their AIFs; clarifying the definition of leveraged AIF by stating that it means an AIF whose exposures are increased by the managing AIFM, whether through borrowing of cash or securities, or leverage embedded in derivative positions or by any other means. This would simply link the existing definition of leverage to the definition of a leveraged AIF; requiring private equity funds to report leverage at the level of the structure in which they invest (i.e. leverage within the holding companies and operational companies that sit below the fund itself). Under the current AIFMD framework, private equity funds do not have to report leverage at this level. This proposal could, depending on whether and how it is implemented, have a significant impact on private equity firms. Most obviously, it could result in private equity structures appearing to be highly leveraged even where lenders have no recourse to the fund itself (nor to its manager or investors). If ESMA's proposal were to be implemented in such a way that private equity AIFs with leverage below the level of the AIF were deemed to be leveraged AIFs, a number of consequences could follow. In particular, sub-threshold AIFMs would need to apply the lower EUR 100 million AUM threshold when considering whether they require authorisation under the AIFMD as opposed to the higher EUR 500 million AUM threshold that applies to unleveraged AIFs. If the AIFMs found that the AUM of the AIFs that they manage did cross the EUR 100 million threshold, they would no longer be sub-threshold AIFMs and would instead need to seek authorisation under the AIFMD and comply with its requirements; and including new reporting fields for environmental, social and governance data. ESMA does not include great detail on the specific fields that should be included and does not cross-refer specifically to the Disclosure Regulation³, which sets out certain requirements for financial market participants with respect to disclosing sustainability risk-related information, but notes the general need for proportionality and consistency in relation to this recommendation.
8.	<p>Harmonisation of supervision of cross-border entities</p> <ul style="list-style-type: none"> ESMA recommends clarifying the responsibilities of home and host member states in the context of cross-border activities (including cross-border marketing and the supervision of branches).

³ Regulation 2019/2088

9.	<p>Semi-professional investors</p> <ul style="list-style-type: none"> • Unlike certain other EU legislation, such as the European Venture Capital Funds Regulation (EuVECA), the AIFMD does not incorporate a concept of 'semi-professional investor' and allows marketing under the AIFMD passport only to professional investors. Retail investors may only be approached under the unharmonised regimes of individual member states. ESMA states in the Letter that, in its view, passporting activities should only be allowed in relation to marketing to professional investors.
10.	<p>Loan origination</p> <ul style="list-style-type: none"> • ESMA recommends the creation of a specific framework for loan origination within the AIFMD. A number of EU member states currently permit certain funds to engage in lending, including the UK, Germany, France and Italy, under relatively light-touch lending regimes. Managers will hope that, if introduced, the new lending framework does not materially restrict their existing business models in these jurisdictions.
11.	<p>Application of depositary rules to CSDs</p> <ul style="list-style-type: none"> • ESMA recommends that the AIFMD and UCITS Directive should be clarified to allow depositaries not to apply the delegation rules to central securities depositaries (CSDs) in their capacity as Issuer CSDs (but that depositaries should be required to apply the delegation rules to CSDs in their capacity as Investor CSDs).
12.	<p>Proportionality for remuneration requirements</p> <ul style="list-style-type: none"> • ESMA calls for clarification that the proportionality principle applies to the full set of AIFMD and UCITS remuneration requirements (which are contained in letters (a) to (r) of paragraph 1 of Annex II of the AIFMD and Article 14b(1)(a) to (r) of the UCITS Directive).
13.	<p>Sub-threshold AIFMs</p> <ul style="list-style-type: none"> • ESMA recommends that the European Commission should consider clarifying the power of EU member states to apply additional requirements to sub-threshold AIFMs.
14.	<p>External valuer liability</p> <ul style="list-style-type: none"> • The AIFMD states that external valuers, where used, must be liable to the AIFM for losses suffered by the AIFM as a result of the external valuer's negligence or intentional failure to perform its tasks. ESMA states that the definition of negligence could be limited to 'gross negligence' (due to the unwillingness from external valuers to accept mandates from AIFMs in certain jurisdictions on the basis that those valuers' liability would cover not only gross negligence but all negligence).
15.	<p>Amendments to definitions</p> <ul style="list-style-type: none"> • ESMA recommends clarifying certain definitions, including: <ul style="list-style-type: none"> - further defining 'AIFs', in a manner consistent with the ESMA guidelines on key concepts of the AIFMD⁴ ; - specifying the distinction between holdings and private equity funds; - clarifying the definition of a joint venture; and - including clear rules on the application of the AIFMD to the issuance of certificates and to crypto assets.
16.	<p>Clear definition and rules for reverse solicitation</p> <ul style="list-style-type: none"> • ESMA recommends clarifying the notion of, and rules applicable to, reverse solicitation, which is currently subject to divergent national interpretations.

⁴ ESMA/2013/611

17.	Convergence in treatment of significant influence <ul style="list-style-type: none">• Article 56(1) of the UCITS Directive states that an investment company or management company acting in connection with all of the 'common funds' which it manages and which falls within the scope of the UCITS Directive shall not acquire shares carrying voting rights which would enable it to exercise significant influence over the management of an issuing body. ESMA recommends clarifying that the calculation of the limit laid down in this article is not limited to common funds or UCITS, but also covers, for example, certain AIFs, portfolios managed on a discretionary basis and investments made by the fund manager on its own account.• ESMA also recommends further EU harmonisation on what constitutes "significant influence".
18.	Increasing digitalisation in the AIFMD <ul style="list-style-type: none">• ESMA notes that the AIFMD review is also an opportunity for the European Commission to allow a greater number of communications in digital as opposed to paper format.
19.	Depositary passport <ul style="list-style-type: none">• ESMA states that, while not recommending the creation of a depositary passport in the AIFMD and the UCITS Directive, the European Commission may study the benefits and risks of such a passport further in the context of the AIFMD review.

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