

# Investment Management Alert

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

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## **AIFMD 'Improvements' Recommended by ESMA — Delegation, Substance and Other (Familiar) Stories**

In a [letter dated August 18, 2020](#), the European Securities and Markets Authority (ESMA) wrote to the European Commission (EC) on certain topics it considers a priority to address in the context of the EC's review of the Alternative Investment Fund Managers Directive (AIFMD), which is occurring seven years after the AIFMD was passed into law on July 22, 2013.

ESMA's letter has attracted a lot of industry attention and was issued following the publication of the EC's [report](#) (dated June 10, 2020) to the European Parliament and the Council of the EU providing an assessment of the functioning of the AIFMD to date. While the EC's report did not conclude that an overhaul of the AIFMD framework is necessary (a fact that was positively received by the asset management industry), ESMA highlighted 19 areas where it sees the need for legislative intervention, and makes recommendations as to how the EU legislator should address the relevant topics.

Of the 19 reform areas listed by ESMA, the proposed changes relating to delegation and substance stand out as the most controversial due to the highly disruptive impact that they could have on the well-established delegation and host alternative investment fund manager (AIFM) models.

### **Delegation and Substance**

Since the introduction of the AIFMD, a number of fund managers (particularly non-EU managers and smaller EU managers) have partnered with fully authorized AIFMs in order to market their funds across Europe. This model rests on the ability, under the AIFMD, for the AIFM to delegate certain functions to suitably qualified and regulated third parties (*e.g.*, the non-EU fund manager).

ESMA's letter expresses concern with this arrangement, highlighting the significant amount of management fees paid to delegates as opposed to the AIFMs themselves as an indicator of extensive delegation arrangements. In view of the U.K.'s withdrawal from the EU, ESMA is additionally concerned that delegation of portfolio management to non-EU entities will further increase, and ESMA therefore recommends changes in relation to delegation and substance in the five areas below.

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## Extent of delegation

In line with its [July 2017 opinion](#) supporting supervisory convergence in the area of investment management in the context of the U.K. withdrawing from the EU and ESMA's general pro-substance approach, the authority recommends: (i) revising or adding to the current limits on the maximum permissible extent of delegation; or (ii) creating a list of core functions that may not be delegated and must always be performed directly by the AIFM.

## The scope of AIFM functions and supporting tasks

ESMA notes the current divergence among national competent authorities (NCAs) as to whether or not certain “supporting tasks” (e.g., legal or compliance tasks, investment research, and quantitative risk data analyses or calculations) performed by AIFM group entities or other third parties fall within the scope of the AIFM functions set out in Annex I of the AIFMD and are therefore subject to the AIFMD delegation rules. ESMA calls upon the European Commission to clarify the list of AIFM functions in line with ESMA's own interpretation set out in Section VIII of ESMA's [Questions and Answers on the Application of the AIFMD](#). Notably, ESMA has held a consistent view that all functions listed in Annex I of the AIFMD (not just the core functions of portfolio management or risk management) qualify as AIFM functions, which may only be delegated in accordance with the AIFMD delegation rules, but this position has not generally been followed by NCAs to date. Although ESMA's view appears to have influenced the supervisory practice of some NCAs, the expansively perceived scope of AIFM functions has been legally challenged by industry participants in those jurisdictions.

## Rules applicable to delegates

In keeping with its theme of leveling the regulatory playing field, ESMA emphasizes that legislative changes are needed to ensure that (both EU and non-EU) delegates perform delegated functions in accordance with the AIFMD rules regardless of their home jurisdiction and regulatory permissions.

## Host AIFMs

ESMA challenges the host AIFM model and highlights the distinct conflicts of interest and investor protection issues that arise in this context (where the fund sponsor is the AIFM's business client and thus able to exert influence and potentially prevent the AIFM from acting in the best interests of the fund's investors). Some NCAs seem to have also expressed concerns regarding the host AIFM model's compliance with the AIFMD. ESMA encourages the European Commission to consider the permissibility of such arrangements and (if they are deemed permissible) whether introducing specific regulatory provisions can address the relevant regulatory concerns.

## Secondment arrangements

ESMA also recommends legislative clarification of the permissibility and regulatory treatment of secondment arrangements (e.g., staff seconded from a professional services firm or another group entity), considering the option's increasing use by AIFMs and the fact that seconded staff often continue to work from their usual work premises (including in another EU member state or even outside of the EU).

Though an area of focus for ESMA, delegation and substance were not the only topics identified for improvement by the authority. Further noteworthy regulatory matters covered in ESMA's letter are set out below.

## Loan Origination

Loan origination by investment funds (whether done domestically or on a cross-border basis) is currently not harmonized as a regulatory matter at the EU level. As a result, debt fund managers need to consider the legal and regulatory framework applicable in the EU member states where they wish to set up their funds or lend to borrowers, and structure their funds accordingly.

In its letter, ESMA reiterates its view (already expressed in its [April 2016 opinion](#) on key principles for a European framework on loan origination by funds) that a specific framework for loan origination funds would aid the long-sought purposes of the Capital Markets Union (CMU). ESMA understands loan origination funds as those that provide credit (*i.e.*, originate a loan) while acting as a sole or a primary lender. ESMA proposes the creation of a dedicated framework within the AIFMD to deal with matters such as authorization, eligible fund characteristics (e.g., closed-ended), diversification, leverage, liquidity and reporting. ESMA argues that loan origination funds should be closed-ended and only marketed to professional and semiprofessional investors.

Given the current national discrepancies regarding the regulatory treatment of loan origination by funds, ESMA's proposed harmonized framework is likely to be, in principle, positively viewed by the private credit industry. How such a fund-specific framework will be incorporated into the AIFMD rules, given their manager focus, however, will be interesting to see. More importantly, ESMA's recommendations do not fully address the core issue of diverging approaches regarding the permissibility of lending by funds in the various EU member states. If loan origination by funds is to be encouraged with the aim of boosting the CMU goals, national restrictions to the lending activity of funds (both on a domestic and on a cross-border basis) will need to be removed with the intervention of the EU legislator.

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## Reporting Exemptions for Private Equity Funds

AIFMs managing private equity funds are not currently required to include in their leverage calculation for such funds any exposure at the portfolio company level (provided that the fund does not risk bearing potential losses beyond its investment in the relevant portfolio company). On the contrary, leverage at the level of any special purpose vehicle (SPV) controlled by the private equity fund must be included in the leverage calculation for the fund where such SPV has been specifically set up to increase the fund's leverage exposure.

ESMA revisits the current position in its letter and notes that the actual leverage employed by private equity funds is being underreported. As a start, it recommends deleting the following sentence from Recital 78 of the AIFMD, with amendments to operative provisions of the AIFMD framework to follow: "In particular for private equity and venture capital funds this means that leverage that exists at the level of a portfolio company is not intended to be included [...]."

ESMA appears to be concerned with private equity funds being overleveraged and, at the same time, underreporting their leverage for regulatory purposes. Proposing the above deletion seems to suggest that leverage should be calculated and reported on a consolidated basis that includes leverage at the level of the private equity fund, its SPVs and (now also) its portfolio companies. ESMA's reasoning for this change of approach is, however, not entirely clear, as leverage at the portfolio company level does not typically increase the investors' exposure regarding their investment in the private equity fund (if it does, such leverage must be included in the fund's leverage calculation under the current AIFMD framework anyway).

## External Valuer Liability

Under the AIFMD, the valuation function may be performed by an independent external valuer providing sufficient professional guarantees as to its qualifications and ability to perform proper valuations. Any such external valuer shall be liable to the AIFM for any losses suffered by the AIFM as a result of the external valuer's negligence or intentional failure to perform its tasks. In some jurisdictions, an external valuer's liability for "negligence" has been interpreted as encompassing both gross negligence and simple negligence, which has made it practically impossible for external valuers to insure their liability (at all or at a reasonable cost). Valuers have consequently become reluctant to accept external valuer mandates within the meaning of the AIFMD.

ESMA acknowledges this problem in its letter and suggests narrowing the concept of "negligence" to gross negligence directly in the EU legislation (in the specific context of external valuers and not elsewhere in the AIFMD).

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## Key Takeaways

Several of ESMA's proposed AIFMD "improvements" have been in its sights for a long time. Among them, ESMA's ardent desire to dismantle the delegation and host AIFM models continues to make the investment industry nervous. Should ESMA's approach to delegation make its way into EU legislation, non-EU managers operating from the world's leading financial centers (such as New York, Hong Kong and non-EU London) may choose to curtail or cease marketing their funds across the European Economic Area (EEA) rather than navigate the various national private placement regimes. For investors in EEA member states where private placement is difficult or impossible, the result will be a smaller range of investment options. A resuscitation of the AIFMD third-country marketing passport would then be particularly important, but there is no current indication that such passport will be activated.

As a consequence of the U.K.'s withdrawal from the EU, the Financial Conduct Authority (FCA) has ceased to be a member of ESMA's various governance bodies and is no longer able to influence ESMA's policy initiatives. The lack of input by the FCA may thus have been one of the reasons for ESMA's uncompromising position in the area of delegation and substance. We should, however, still expect intense lobbying against the proposed reforms from EU member states such as Luxembourg, Malta, Cyprus and Ireland as well as from the EU and non-EU asset management industry itself.

Whether the European Commission will take ESMA's recommendations on board in a set of proposals for the amendment of the AIFMD framework remains to be seen. ESMA issued its letter on its own initiative and anticipated undertaking potential additional work (*e.g.*, technical advice) as a result of the AIFMD review in its [2020 Annual Work Programme](#); however, if, when and how the European Commission will respond to ESMA's letter is unclear. While the investment industry would welcome the legislative clarification of certain concepts that have led to frustrating levels of regulatory divergence across the EU, increased harmonization is unlikely to balance the potential disruption that would result from the adoption of some of the proposals highlighted above.