AIFMD REVIEW

The Chair noted that the review of the Alternative Investment Fund Managers Directive (AIFMD) has been initiated[1]. KPMG was asked for a report on whether the objectives of the AIFMD have been achieved and what changes might be needed. The conclusion of this report is that the basic objectives of the Directive have been met: the AIFMD has played a significant role in helping to create an internal market for AIFs and a harmonized and stringent regulatory environment for AIFMs. The report however identified several areas of potential weakness related notably to a different interpretation of rules across EU Member States (e.g. regarding depositary and marketing rules), overlaps or inconsistencies with other EU requirements (e.g. in the areas of reporting and leverage) and overly burdensome rules (for investments in non-listed companies).

1. Progress made with the AIFMD in creating an internal market for AIFs

1.1. Further integration of the EU AIF market

The AIFMD's first objective is the creation of an internal market for alternative investment funds (AIFs), the Chair noted. However the small percentage - less than 3% - of AIFs distributed in more than three countries, shows that this is not yet a pan-European market. The risk is for the EU AIF industry to lag behind other regions.

A Central Bank official stated that KPMG's conclusion that significant progress has been made in developing an EU single market for AIFs is consistent with ESMA data showing an AIF sector of € 5 trillion assets under management, representing a third of the EU fund industry and still growing. All objectives have not yet been achieved in this regard, but the directive has had positive impact. A single rulebook was established with a strong set of common rules. Following the ESAs review, progress should be made in terms of supervisory convergence. This should help to ensure a more consistent implementation of the AIFMD rules, provided that supervisors coordinate and use the tools at their disposal to deal with common issues consistently, together with ESMA. Any further changes required with regard to AIFMD should be made through enhanced supervisory coordination rather than Level 1 changes, the official suggested.

An industry representative emphasized that the initial objective of AIFMD was to tackle the risks posed by hedge funds and other alternative funds, but it was complemented later on by the objective to create a single market for AIFs limited to professional investors, due to the risks involved. Bearing this in mind, the speaker felt that the single market for AIFs works relatively well in practice. The industry representative moreover noted that the regulation adopted earlier in 2019 and due to be implemented by August 2021 to favour the cross-border distribution and marketing of UCITS and AIF funds should foster the integration of the EU AIF market. This legislation is positive but will mean adapting the passporting of AIFs and UCITS, the way legal documentation is drafted and the management of IT processes and systems in order to facilitate cross-border marketing. This must be done step by step, not in parallel with changes to AIFMD. The cross-border marketing legislation should be implemented first and assessments should be conducted to verify whether passporting has improved as a result, before making significant changes to AIFMD.

A regulator agreed that the cross-border fund distribution regulation could help to enhance the percentage of AIFs distributed cross-border, which is low at present. The impact of this regulation may however be different for AIFs and UCITS, because UCITS benefit from a larger distribution.

1.2. Depositary location requirements

An industry representative stressed that depositary rules are also important in building confidence, safety and soundness in the AIF sector and therefore need to be considered in the context of the AIFMD review. Differences in the local implementation of these rules have not been material enough to cause problems, however there is still potential to reduce cross-border frictions in this area and to contribute to deepening the EU AIF market. In particular, the rules relating to depositary location should be reconsidered in the context of the AIFMD review, the speaker believed. The current system requires that depositaries to EU AIFs must be established in the home member state of the AIF. Although the intent is understandable, it has led to a fragmented system where depositary quality and the level of competition vary by location across the EU. Changing this could improve options for managers without undermining the rest of the AIFMD rule set. Much time was also spent during the drafting of the AIFMD legislation on defining depositary liability, but the current set up remains untested and may not be optimal, the speaker felt.

A regulator recognised the interest of large financial institutions in centralising their activities in order to reduce costs. Regulators however need to ensure that outcomes are also positive for investors, which might increase some costs for the industry. In addition there is already a great deal of competition on fund depositary services in Europe. The depositary bank function is crucial when constructing an investment fund, as it provides assurance to investors. Decoupling a fund's domicile from that of the depositary bank creates issues with the legal framework, although this may be overcome. The main problem is that national safekeeping laws are different across jurisdictions, raising the question of which regulation applies if a fund appoints a depositary in another jurisdiction. A regulator will insist that the fund's home law applies, since that is the one under which investors have invested and this provides them with the protection to which they are entitled. In addition, an important activity for a depositary bank in Europe is controlling the fund's flows of money and to which counterparty they are going. This refers to the national prerogative of anti-money laundering (AML) legislation in particular. It would be difficult to have a product domiciled in one country where another party would be subject to different AML legislation in Europe, let alone in a third country. Moreover there are systemic risks associated with fund activities. Concentrating the depositary activity in a few jurisdictions and in a very limited number of firms will create additional risks.

The industry representative acknowledged that these different issues need to be further assessed and that discussion on them during the AIFMD review would be welcomed. Depositary banks are EU domiciled and regulated banks and a certain level of equivalence across borders is needed for markets to work effectively on a pan-European basis, including in this area. A possibility could be to allow for central operation out of a core custody bank and to address local concerns such as AML through a lighter registration regime or through data sharing. This would be beneficial for smaller member states and for managers who would like to work across borders through a relationship with a single depositary.

A Central Bank official agreed that depositary location is an issue to be further assessed. Achieving a more coordinated and consolidated approach in this area is a trajectory that is worth considering after the initial progress made with the implementation of AIFMD rules.

1.3. Additional issues suggested for the AIFMD review

A Central Bank official suggested that loan origination funds are an area that also needs reviewing. EU jurisdictions have domestic regimes for these funds that show some similarities and ESMA has laid down common principles. A more consistent approach across Europe in this area would be beneficial, because this is a key aspect of the evolving post-crisis landscape.

An industry representative observed that the limited use of administrative measures and sanctions by regulators is identified as a weakness in the KPMG report. Similar assessments conducted by ESMA[2] regarding UCITS showed that in 2016 and 2017, less than 50% of national competent authorities (NCAs) within the European Economic Area (EEA) issued an administrative measure or a sanction regarding these funds, which normally involve a higher level of investor protection due to their retail orientation. It is essential that a similar report should be prepared by ESMA for AIFs before possible revisions to the existing rules are considered, in order to have a sufficiently evidence-based approach. The speaker also reminded the audience that there is a Level 4 in the Lamfalussy process, whereby the Commission should monitor the actual enforcement of already adopted EU laws. However, until now, the Commission's compliance with this requirement has been poor, including for AIFMD.

2. Progress made in terms of risk mitigation

2.1. Achievements of AIFMD in terms of risk mitigation

The Chair stated that the need for a specific regulation for managing the risks posed by AIFs had appeared after the financial crisis. As the focus was initially on hedge funds and private equity funds, it was a surprise when the Commission decided to address all AIFs, which are a heterogenous group, including for example real estate funds and the so-called 'special' funds[3]. Such a diverse group of funds could not be regulated at the product level, so the compromise was to regulate fund management companies via the AIFMD.

An industry representative considered that the systemic risk management objectives of AIFMD have been largely achieved. AIF managers have experienced various market events since the implementation of AIFMD, including the Brexit referendum and the end of the Euro crisis, with no particular problem.

A Central Bank official did not believe that all the objectives on the risk side have been achieved. Much remains to be done on liquidity and leverage risks in particular, which may create systemic risks. The crisis showed that what can work at the individual fund level may not give the desired systemic outcome at sector level. There is ongoing work on AIFMD notably on the implementation of Article 25 relating to leverage limits set by AIFs and the ability of the competent authorities to intervene on leverage levels. The European Systemic Risk Board (ESRB) recommendations on mitigating liquidity and leverage risks in investment funds also need considering in this perspective. In doing so it is important to understand the dynamics of the non-bank financial sector and define what the public interest should be in order to determine the type of macroprudential tools and requirements that are needed for possible intervention on an ex-ante and ex-post basis. This involves examining a range of questions and the AIFMD review must not prejudge the answers.

A regulator acknowledged the existence of several areas for improvement. Both the microprudential and macroeconomic views are key to risk management. AIFMD is principle-based and takes a holistic approach to liquidity, leverage, operational risk and other issues, drawing on the experience of UCITS. Areas for improvement include a stronger harmonisation of leverage definitions and reporting rules, given that asset managers have multiple licences and manage multiple products and are seeking to streamline processes as much as possible across funds. A second issue is the segregation between risk and portfolio management. It is quite strict in the case of UCITS and the KPMG review asks if there is a similar issue for AIFs. Depending on the type of alternative fund managed, risk and portfolio management are quite close. The implementation of the proportionality principle must also be reviewed again. Finally, the macroprudential focus is on leverage, although other risk categories must be considered. The methodology must be fine-tuned to adapt risk management to different asset classes, as this cannot be a one-size-fits-all.

2.2. Liquidity risks posed by AIFs

A Central Bank official noted that liquidity risks need to be addressed both from a systemic risk and investor protection point of view, as shown by the recent examples of Woodford, H2O AM and GAM funds. Progress has been made through the work of IOSCO and ESMA on stress-testing guidelines, but it is important to assess if this provides the necessary investor protection.

An industry representative noted that the Woodford funds incriminated were not structured as AIFs but as UCITS and so this issue would fit better in a debate about the liquidity risks of UCITS. The design of UCITS funds is different from AIFs and there is a higher investor protection objective, given their stronger retail nature. For AIFs, the debate is mainly about ensuring that the existing liquidity rules are enforced.

A Central Bank official agreed with this distinction but considered that while the functioning of these funds may be different, the questions on investor protection are the same. It may be that there is a different answer for AIFs, but this issue still needs reviewing to check whether sufficient progress has been made, taking into account the dynamics in the financial system as a whole.

A market expert advised that cases such as the Woodford or Third Avenue funds must be reviewed in a broader historical context, taking all the different implications into account. Third Avenue is only the fourth regulated fund in the US industry's history that has had to suspend redemptions. This had no systemic effect and yet, following this event, the US SEC created a vast framework of liquidity risk management, despite indications that the industry was managing those risks well, considering the wider effects on the system or fund sector.

The same is true of Woodford, the market expert stated. The fact that the fall of the fund had no knock-on effects across the UK or EU market suggests that it was not a systemic event and does not require new regulatory interventions. It also demonstrates that the fund market is robust. The aim is indeed to build robust systems rather than stable ones, because stable systems are essentially moribund with nothing happening to them, even after a shock. A robust system is built in a more dynamic perspective. It allows people to take risks and is able to endure shocks and continue to work, once issues have been tackled. An efficient financial system should be a robust system, not a stable one, because people should be able to take risks and put invested money to work. In some instances, money will be lost but a balance must be maintained between serving the economy and maintaining investor trust and confidence with a sufficient level of protection.

If there is an idiosyncratic event, regulators must question what the appropriate response is, having weighed all the costs and benefits in that context. The SEC got it wrong on that occasion, the speaker felt. The required liquidity risk bucketing is proving to be extraordinarily expensive, especially for small funds and the industry is now in the hands of service providers and consultants, who charge vast amounts for bucketing. In addition prescribing a unique set of liquidity management rules across such a diverse industry in terms of asset classes, sizes of funds and levels of risk is very difficult.

A Central Bank official agreed that Woodford was not a financial stability event. However when such an event happens it is important to understand its potential systemic and investor protection consequences, because the possibility of a shock or the potential ‘crystallisation’ effects on the market need to be anticipated. This does not necessarily mean introducing new rules, but understanding how problems appear if there is a shock in the fund sector. A stable system is good to have, it is a static one that should be avoided.

The expert agreed that assessing the potential risks is important, provided that any risks are not seen as a harbinger of negative circumstances yet to come. Reviewing every major US market event since 1940 shows that predictions about flight, panic or run risk generally never come to pass.

3. Brexit implications and third-country issues

3.1. Brexit implications for AIFs

The Chair advised that the UK leaving the EU and therefore becoming a third-country at some stage, raises again the question of how to treat non-EU AIFMs and AIFs, and whether the current approach to third-countries in the AIFMD requires any change.

A market expert responded that the internal AIF market will look much smaller after Brexit since much of the AIF management is in the UK. The main challenge may not be the rules to apply to non-EU players, but rather how to nurture the industry within the EU post-Brexit. A special form of portfolio expertise is required for hedge funds, private equity or venture capital. The financial characteristics and infrastructure required are also different from other regulated funds. The EU’s challenge will be to encourage the AIF sector to develop in the future and encourage investors to embrace it.

An industry representative stated that the EU industry has been preparing for a hard Brexit since the result of the 2016 referendum, given the uncertainty that was created. The asset manager represented by the industry speaker is particularly well placed, having fully-fledged legal entities in the UK and in several EU27 countries now, with asset management capabilities and an internal broker with a MiFID licence. Moves have been made to secure access to derivatives also.

A regulator noted that UK regulators have decided to onboard EU rules. There should therefore be equivalence in the short term at least, since the laws will not change, which is positive. Moreover, the question of equivalence with the UK needs to be considered in a context where portfolio management activities have been delegated outside Europe to the US, Hong Kong and others for many years.

A Central Bank official believed that defining what to do on the third country aspects of AIFMD and how to apply equivalence in this area is challenging and Brexit makes it even more so. The national private placement approach works reasonably well. Difficult discussions have taken place over the past year in the context of Brexit around third-country delegation and applying a third-country regime to CCPs and investment firms. This has allowed the identification of the main questions to focus on from a regulatory perspective i.e. whether there is a financial stability concern that arises from having two jurisdictions where there was previously one and how to ensure that supervision is effective and that the relevant norms and standards apply in each jurisdiction. The debates have become more depoliticised over time, the official believed, which is positive, but we need to stick to the relevant questions.

3.2. Third-country AIFs

A market expert stated that the issue of third-country AIFs had been raised again when ESMA was asked to provide the Commission with advice on the possibility of extending the AIFMD passport to non-EU AIFMs and AIFs from different third-country jurisdictions including the US. They did not find any investor protection or systemic risk issues with respect to US funds. There was however a misunderstanding of the way the US fund system works, because it was assumed in the comparison that the rules for regulated US funds apply to European private funds that are offered in the US market, which is not the case. The predicate for deciding that the AIFMD passport would not be eligible for US funds is therefore wrong. This signals a broader inclination to exclude third-party funds from the EU market, the speaker felt.

An industry representative observed that bringing US fund products into the EU under current EU rules including AIFMD, PRIIPs and UCITS is challenging at present. This means that some of the most liquid exchange-traded funds (ETF) in the world for example are not available in Europe, which raises questions that go beyond the AIFMD regulatory discussions. Reviewing third-country access rules is necessary in the context of a European-based market that is potentially due to shrink post-Brexit, the speaker felt.

4. Reporting requirements

A regulator stated that the issue of reporting has been raised in the context of the AIFMD review. There are often complaints from the market that data is filed, and then no feedback is received. As for regulators, they point out data quality issues, particularly regarding investment strategies and the ‘other- other category’ which is considered to be too vague. These areas should be reviewed to make the reporting more meaningful going forward.

An industry representative believed that the current reporting provided is sufficient for monitoring purposes and that there is no need to change it or extend it. Two different sets of reporting are already required by AIFMD and UCITS and central banks e.g. in Luxembourg and France also ask for inventories of each of the funds domiciled in their respective countries. If supervisors want more detailed reporting than what is provided via AIFMD requirements they should obtain

them from the central banks, rather than imposing additional reporting requirements on the industry. More generally, further coordination among securities regulators through ESMA or between banking supervisors and/or central banks and local securities regulators would facilitate the sharing of the data and help to improve the data at the disposal of the authorities. The regulator clarified that they are looking for a better outcome in terms of data quality, especially for the category of 'other-other' funds and not for additional input of data from the industry.

The Chair noted that the KPMG report also highlighted consistency of reporting as a weak point and asked if NCAs interpret and implement the existing reporting rules differently. An industry representative agreed that these comparability issues between reporting requirements across EU jurisdictions should be further assessed.

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[1] The Alternative Investment Fund Managers Directive (AIFMD) requires a review of the Directive (review of the application of the AIFMD; its impact on investors, AIFs and AIFMs within the EU and in third countries; and the degree to which the objectives of the Directive have been met). The first stage of the review has been completed with the publication on 10 January 2019 by the Commission of a report commissioned from KPMG intended to provide and assess evidence for the Commission's review. The Commission has indicated that it will continue its work on the AIFMD review, taking into consideration the information and conclusions contained in this report, alongside other sources of data and further analysis. The intention is for the Commission to issue its own report on the functioning of the AIFMD to the EU Parliament and Council in 2020.

[2] ESMA released a report on the enforcement of administrative measures and sanctions for UCITS on 4 April 2019.

[3] Spezialfunds are predominantly German funds limited to institutional investors such as insurance companies or pension funds, allowing for a more lenient regulatory framework compared to retail funds. These funds are often based on one investor.