EFAMA

European Fund and Asset Management Association

POSITION PAPER

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TWEAKING THE AIFMD/UCITS FRAMEWORK

Executive Summary

EFAMA welcomes the decision of the European Commission to adopt a targeted approach in its review of the Alternative Investment Fund Management Directive (**AIFMD**), along with key harmonising provisions within the Undertakings for Collective Investment in Transferrable Securities Directive (**UCITSD**). This focus on targeted improvements recognises the role this framework has played in encouraging the growth in the European Alternative Investment Fund (**AIF**) market over the past decade and its resilience even throughout recent market stresses. EFAMA supports the intent behind the Commission's proposals in many respects, although certain of the proposed amendments warrant further consideration to ensure against unintended consequences which may outweigh the benefits envisaged. Our key suggestions for the proposed Directive are summarised as follows:

Liquidity Management Tools

While we strongly welcome the list of LMTs included in Annex V to the AIFMD and Annex IIa to the UCITSD, it is critical that the management of liquidity risk remains the responsibility of the manager. Liquidity risk is a function of, and is directly related to, the characteristics of the fund being managed. Removing this function from the manager or imposing prescriptive triggers for activating LMTs risks giving rise to pro-cyclical effects, for example by creating a risk of run on funds where the imposition of a particular LMT is anticipated by investors in the market.

Loan Originating Funds

EFAMA agrees that loan originating funds can provide a tangible benefit for the real economy, as noted in the Commission's Explanatory Note. It remains unclear, however, as to the rationale behind introducing rules specific only to loans and why the current principles (which have been designed to apply to all asset classes without distinction) are considered insufficient for this category of asset. EFAMA would caution that certain rules in fact contradict established market practice and as such would have the effect of reversing the growth of this industry and potentially making these products less accessible and attractive to investors. We would contend that the current framework is sufficient to regulate originated loans as an asset class.

Supervisory Reporting

EFAMA welcomes the review to be carried out by ESMA as regards opportunities for the sharing of data between different regulators, including giving NCAs access to data reported by managers to national central banks (NCBs). As per the aim of the European Strategy on Supervisory Data in EU Financial Services to modernise EU supervisory reporting while 'minimising the aggregate reporting burden for all relevant parties', managers should not be required to report more granular data which would be of no added benefit for supervisors and which may have already been reported to a different supervisor under a separate piece of legislation. The focus should thus remain on communicating meaningful data and not unnecessarily duplicating, or increasing reporting obligations for managers. Any proposal to introduce a supervisory reporting regime for UCITS funds must also recall the stringent rules to which these funds are subject.

Delegation

EFAMA welcomes the acknowledgement that delegation is an important factor for the success of the European fund industry. The targeted amendments proposed by the Commission will increase transparency and supervisory convergence in the area of delegation without undermining the underlying regime. The proposal should nonetheless specify that delegation rules should not apply to tasks for which the management company does not bear direct responsibility. As regards the envisaged delegation-related reporting regime, the objective pursued by this regime should be clearly spelled-out. Moreover, NCAs should be allowed to take into account qualitative criteria when determining which arrangements to report. EFAMA finally questions the appropriateness to mandate regular peer reviews at Level 1 considering that ESMA is supposed to be a risk-based supervisor.

Depositary Services

EFAMA welcomes the decision of the European Commission to not introduce a depositary passport, believing that the requirement for the depositary to share the same domicile as the fund is an essential safeguard for investor protection. We also strongly support the decision to extend the depositary regime to include "investor" CSDs in the custody chain in order to guarantee the same liability standards applied to a fund depositary. When an NCA intends to take advantage of the possibility of appointing a depositary service in another Member State, it should as a precondition prove the lack of sufficient depositary service offer in its own jurisdiction.

Disclosures

EFAMA believes that the existing disclosures through UCITS, PRIIPs and MiFID legislations are already sufficient and allow investors to make informed investment decisions. Adding a new set of rules would only create confusion and complicate fund managers' task to comply with several, yet overlapping, requirements. In addition, it is crucial to keep in mind that an AIFM needs the necessary flexibility in order to tailor the information provided to the specific needs of its investors. Mandatory retail investor-type disclosure – as established by MiFID – might lead to the situation where non-relevant information is disclosed to professional investors.

Procedural Provisions

The proposed rules will have an impact on all existing AIFMs and UCITS funds active in the EU. As such, certain rules will need to be grandfathered in the interest of legal certainty and to avoid retroactive effects. In addition, the content of a number of the provisions is to be specified via delegated acts or implementing technical standards and should, as such, not apply until an appropriate period of time after the entry into force of these implementing legislative acts.

INTRODUCTION

EFAMA welcomes the European Commission's review of the Alternative Investment Fund Management Directive (**AIFMD**), setting out targeted improvements to key provisions in the current framework. Such targeted improvements will make strides in advancing the Capital Markets Union while maintaining the framework which has underpinned a decade of growth in the European Alternative Investment Fund (**AIF**) market and proven resilient even throughout recent market stresses.

EFAMA supports the proposal's intent to harmonise the availability of liquidity management tools (**LMTs**) across EU jurisdictions, while cautioning against the introduction of overly prescriptive rules. In general, LMTs should evolve in line with developments in the market and their activation should be at the manager's discretion in light of the individual characteristics of the funds it manages. The association is also pleased to see the inclusion of certain Central Securities Depositories (**CSDs**) in the custody chain when providing services to UCITS and AIFs, which will enhance investor protection.

EFAMA also welcomes the intention to reduce duplication among the numerous reporting regimes applicable to AIFs, while equally pointing out that this should begin with an improved exchange of data between public authorities, particularly with central banks. As UCITS funds are already subject to strict product rules, EFAMA also questions the utility of introducing a reporting regime for them. Existing product rules include restrictions on eligible assets, financial borrowing and derivatives trading, all of which limit the risks such funds may represent to the financial system.

We remain cautious around some of the proposed changes to the delegation and outsourcing requirements and the unintended consequences such changes may have on a tried and tested delegation regime that works to the benefit of investors. Furthermore, EFAMA is of the view that the AIFMD should remain a manager directive. Creating product-specific rules within a framework designed to encompass all asset classes would risk creating anomalies between investment strategies and unintended obstacles to the marketing of, and access to, AIFs.

I. Liquidity management

EFAMA welcomes the Commission's proposal to make available the full suite of proposed LMTs across all Member States as a means of managing liquidity risks and ensuring the fair treatment of investors.

We would caution, however, that overly-prescriptive specifications as to when such LMTs can be triggered may have negative implications for both financial stability and investor protection and should be avoided in favour of maintaining manager's discretion, while promoting transparency in their use of LMTs.

- **Financial stability**. The management of liquidity risk as a function is directly linked to the investment strategy of the fund, its underlying assets and nature of its investor base. Its characteristics must therefore be tailored to these factors. Imposing a one-size-fits-all approach would be inappropriate given the widely different profiles of investment funds and of their investors, as well as the different potential market events which could occur. Such approach would risk giving rise to pro-cyclical effects by amplifying the market risks sought to be avoided. For example, introducing automatic or prescriptive triggering of similar LMTs under similar circumstances would risk pro-cyclicality, a potential rush for redemption where investors may predict when LMTs may be imposed or may unnecessarily constrain market finance leading to further market pressures. Importantly, centralising the decision to impose a given LMT would displace the manager's intimate knowledge of the fund's liquidity profile, underlying assets, redemption policy and underlying investors, and interfere with his/her fiduciary duty to act in the best interest of the fund's investors.

- **Investor protection.** Liquidity risk management has a dual purpose of protecting the investor and the financial system at large. The selection of LMT must balance both considerations. The manager, having a greater familiarity with the underlying investors and the fund as a whole, will be in the best position to select the LMT which will protect remaining investors against, for example, the 'first-mover advantage', as well as ensuring against any wider implications taking into consideration the specific circumstances at hand which may be difficult to anticipate in advance.

Policy Recommendations

1. **Activation/Deactivation of LMTs by NCAs/ESMA – Articles 46(2)(j), 47(4)(d) and 50(5b),(5f) and (7) AIFMD; Article 84(2), 84(3b) and 98(3) UCITSD**

As regards the power of national competent authorities (NCAs) and ESMA to request the activation or deactivation of specific LMTs, EFAMA notes that this power is currently available for NCAs as regards suspension of redemptions and we would **caution against expanding this power to require the activation of further LMTs other than redemption gates, noting that the intervention by authorities should take place in exceptional circumstances and only following consultation with the fund manager.**

The discretion and knowledge of the manager is key in effective liquidity management, as noted above. Any role for authorities to activate an LMT in place of the manager should be permitted only on the basis of consultation with the fund manager and in extraordinary circumstances of imminent and defined systemic risk. As such, EFAMA is of the opinion that the current powers are sufficient in this regard.

The role of authorities in this area could instead be enhanced by requiring enhanced reporting of the activation of LMTs on an ad hoc basis, as provided for in the draft proposal, in situations indicative of market stress and in advising on the appropriate LMTs to include in the fund rules at the fund establishment stage. It should be borne in mind that NCAs in practice play a key role in assessing the appropriate means of managing liquidity risk, both prior to granting authorisation for the fund, as well as on an ongoing basis via close supervision during normal market conditions and targeted reporting and oversight during stressed market conditions. In order to secure authorisation for the fund prior to its launch, asset managers (with input from the investment, risk, compliance and operations functions of the fund) work in close contact with NCAs to determine the appropriate means of managing the liquidity of that fund, determining its structure, redemption frequency and other LMTs.

Regard must also be had to the in-depth and tailored methods put in place by managers for each individual fund over its lifetime. Following authorisation by the NCA, the fund manager puts in place contingency plans and liquidity controls which are performed regularly over the fund life (such as stress testing) and on a periodic basis. Where thresholds are exceeded or other alerts triggered, this results in discussions as to appropriate remedial actions. Ongoing dialogue with investors as to their intentions is also of critical importance, particularly in the case of larger holdings. EFAMA would caution against an approach which allows a centralised authority to side-step these tailored internal controls.

We would also note that requiring the activation of redemption gates regardless of whether this has been selected by the manager under Art. 16(2b) would undermine investors' legal certainty.

EFAMA Recommendations

EFAMA recommends that NCAs and ESMA be granted the power to request the manager to suspend redemptions or impose redemption gates in exceptional cases where circumstances so require and

where suspension or the imposition of redemption gates is justified having regard to the interests of the unit-holders and to any financial stability risks that necessitate this requirement in consultation with the manager.

EFAMA recommends that the RTS to be drafted by ESMA under Article 50(7) specifying the situations in which NCAs may require activation of LMTs should specify that the drafting of these RTS shall consider, in addition to investor protection and financial stability, the importance for the primary responsibility for liquidity risk management to remain with the fund manager and for the intervention of NCAs to operate only as a last resort.

We also recommend that Article 16(2b) should refer to LMTs listed at points 3 to 5 of Annex V (see further comments below), reflecting that gates will in effect have to be available for activation in case of NCA intervention.

2. Selection of LMTs by the manager – Articles 16(2f) and 2(g) AIFMD; Article 18a(3) and 18a(4) UCITSD

As outlined above, the management of liquidity risk is a direct function of the characteristics of the fund, which vary widely from fund to fund. The manager must be able to tailor the decision as to which LMTs to use depending on these characteristics as well as in response to external pressures and the behaviour of underlying investors. Similarly, the internal processes highlighted above provide managers with valuable information to support their decision as to how best manage liquidity risks. Added to this is the wealth of existing industry guidance developed by industry bodies in a number of EU jurisdictions, as outlined in more detail in EFAMA and AMIC's joint report on fund liquidity management.[1]

As such, any specification as to the **criteria for the selection and use of suitable liquidity management tools by managers should adopt a principles-based approach** by reference to existing guidance across EU jurisdictions as opposed to setting out prescriptive rules as regards instances where specific LMTs should be triggered. The latter approach would risk depleting the manager's responsibility for managing liquidity risks of the fund in favour of a formulaic approach, as well as risking procyclical effects – for example, where investors can anticipate the imposition of an LMT, triggering a rush for redemption. EFAMA would also recommend that any such criteria be **set out by way of guidance by ESMA as opposed to delegated act**, enabling the criteria to better respond to and evolve with the experience of industry and the market.

Similarly, any **regulatory technical standards specifying the characteristics of liquidity management tools should leave room for these tools to develop and evolve in response to new market practices and products**. As above, a more flexible approach in the form of guidelines would best ensure these aims.

EFAMA Recommendations

EFAMA recommends that Article 16(2g) AIFMD and Article 18a(4) UCITS be amended to refer to 'principles for liquidity management' as opposed to 'criteria for the selection and use' of LMTs. It should also be amended to refer to guidance as opposed to regulatory technical standards. EFAMA would also welcome a similar reference to guidance as opposed to regulatory technical standards in Article 16(2f) AIFMD and Article 18a(3) UCITS.

[1] EFAMA and AMIC's joint response on fund liquidity management by open-ended funds to IOSCO (22 April 2021), p. 7 – 8.

3. Notification of activation/deactivation of LMTs – Article 16(2d) AIFMD; Article 84(3) UCITSD

EFAMA recognises the importance of transparency in the use of LMTs particularly in times of stressed market conditions. We fully agree that NCAs should be informed and notified of any suspensions of redemption or imposition of gates by management companies, as these LMTs are reserved for use only in exceptional circumstances where there have either been a significantly higher number of redemption requests or where the liquidity of the underlying assets has been significantly impaired.

We would note that, apart from suspension and gates, the remaining LMTs may be used in both ordinary and exceptional circumstances. The use of certain LMTs may be set out in the terms of the fund's shares and apply as per the process outlined in the rules of the fund. As regards notice periods, for example, investment funds put in place notice periods during which requests for subscription and redemption of units in the fund are received. As currently drafted, however, Article 16(2d) would require any activation/deactivation of the LMTs mentioned at Art. 16(2b) (i.e., suspension of redemptions, gates, notice periods and redemption fees) to be notified.

We trust it is not the intention of the Commission for information about routine activation of LMTs to be transmitted to NCAs and onward to ESMA and the ESRB, which would prove a disproportionate burden and contribute little to effective supervision, but rather in more exceptional circumstances indicative of a situation of liquidity stress. We would suggest, as such, that the text be amended such that NCAs would be notified only of the use of LMTs in situations of liquidity stress as opposed to their routine use as provided for in the terms of the fund's rules or instrument of incorporation.

EFAMA RECOMMENDATIONS

EFAMA recommends amending Article 16(2d) AIFMD and Article 84(3) UCITS to refer to a notification being required when activating an LMT otherwise than in the ordinary course of business, as envisaged in the fund documentation.

4. LMTs to be made available by the manager – Article 16(2b) AIFMD; Article 18a(2) UCITSD

As noted above, EFAMA welcomes the availability of the full toolkit of LMTs to managers active in Europe. EFAMA would, however, suggest broadening this list of LMTs referred to in Article 16(2b) AIFMD and Article 18a(2) UCITSD, of which the manager must choose at least one, to also **include swing pricing**. This is in recognition of the prominent usage of swing pricing during, for example, the March/April 2020 market downturn – as noted in ESMA's November 2020 report on the ESRB's recommendations on liquidity risk management, the use of swing pricing was more widespread compared to other LMTs, indicating a decision by managers to 'use swing pricing to treat fairly remaining investors, by passing part of the cost of liquidity to redeeming investors.'[2]

Swing pricing allows for fair treatment of investors due to its ability to reflect the anticipated transaction costs associated with exiting the fund – the price the exiting investor pays will depend on a 'swing factor' which reflects the anticipated cost of transacting in the assets of the fund to facilitate the redemption, varying based on the class of asset, net flows and market conditions. This not only protects remaining investors from the dilution of the fund, but also incentivises investors to remain invested, or to stagger their redemption requests – as noted in the ESRB's recommendations, swing pricing plays a role not only in

[2] ESMA Report, 'Recommendation of the European Systemic Risk Board (ESRB) on liquidity risk in investment funds' (20 November 2020), at para 84.

disincentivising procyclical behaviour but can actually incentivise anticyclical behaviour (i.e. to subscribe during a redemption phase).[3]

EFAMA RECOMMENDATIONS

EFAMA recommends amending Article 16(2b) AIFMD and Article 18a(2) UCITSD to refer to the tools listed at points 2 to 5 of Annex V and Annex IIa, respectively.

II. Loan origination

We agree with the Commission's recognition of loan origination being an important source of alternative financing for the real economy, as noted in its Explanatory Memorandum to the proposed directive. In addition to providing critical funding for EU SMEs to whom traditional lending sources may be unavailable, loan funds can provide much needed capital for projects pursuing sustainable objectives or promoting environmental or social characteristics, with the number of loan funds classified as Article 8 or 9 SFDR expected to surge in the coming years.[4] EFAMA is hopeful for the potential loan funds hold in achieving positive growth in the real economy and in achieving sustainability objectives.

Policy Recommendations

1. Removal of Product-Specific Rules

Overall, EFAMA recommends against introducing product-specific rules applicable to loan originating funds. The pre-existing rules within the AIFMD are designed to be applicable to all categories of assets, as noted in Recital 10:

> *"This Directive does not regulate AIFs. … It would be disproportionate to regulate the structure or composition of the portfolios of AIFs managed by AIFMs at Union level and it would be difficult to provide for such extensive harmonisation due to the very diverse types of AIFs managed by AIFMs."*

It is unclear why these rules are not considered sufficient for this category of assets. Aside from creating anomalies between investment strategies, such rules would in practice negatively impact the growth of this area in the absence of evidence of market failure or risk thereof to justify a departure from the existing framework. We have set out below our reaction to certain of the proposed rules while maintaining our stance against the introduction of product-specific rules in the AIFMD.

EFAMA RECOMMENDATION

EFAMA recommends against the proposed introduction of product-specific rules in Article 15 and 16 of the AIFMD. In the event that this recommendation is not followed, we have set out below suggested amendments to those proposed articles as a second preference.

[3] Recommendation of the European Systemic Risk Board of 7 December 2017 on liquidity and leverage risks in investment funds (ESRB/2017/6), Recommendation A.
[4] ALFI and KPMG Private debt fund survey 2021, available at https://www.alfi.lu/getattachment/4ade2c61-d64d-40c6-b38c-627386bb9638/app_data-import-alfi-private-debt-fund-survey-2021.pdf.

2. Cross-border activities

EFAMA notes the intention of the amendment to Annex I of the AIFMD inserting a reference to origination of loans, which the Explanatory Notes state as being *'to enable AIFs to extend credit to businesses across the border'*. EFAMA agrees with the Commission's assessment as to the positive impact of loan funds for the real economy by *'open[ing] up alternative sources of financing for SMEs'* in particular, as well as sources of important capital for ESG related projects.

As recognised by the Commission in its Explanatory Notes, *"diverging national regulatory approaches undermine the establishment of an efficient internal market for loan-originating AIFs by promoting regulatory arbitrage and varying levels of investor protection."* We would agree that the divergence in national regulation represents an obstacle to the ability to originate loans cross-border. As drafted, it remains unclear whether existing national rules requiring additional requirements for managers, such as the obtaining of licenses, may continue in effect. As such, EFAMA would suggest including these quoted intentions in the Recitals to the Directive, as opposed to only in the Explanatory Notes in order to clarify the intended impact of the amendment to Annex I on pre-existing national regulatory approaches.

EFAMA RECOMMENDATION

EFAMA recommends including a Recital which reflects the wording of the Explanatory Memorandum, explaining that the amendment to Annex I of the AIFMD is intended to remove 'diverging national regulator approaches [which] undermine the establishment of an efficient internal market for loan-originating AIFs' and thereby 'enable AIFs to extend credit to businesses across the border'.

3. Closed-ended structure – Article 16(2a)

The draft directive provides that an AIF must be closed-ended if the notional value of its originated loans exceeds 60% of its net asset value. While understanding the Commission's aim of ensuring against liquidity mismatches, we would assert that the existing and proposed range of provisions on liquidity management provide adequate protection for all asset classes including loans originated by the fund.

The current rules under the AIFMD require managers to ensure that the redemption policy of the fund is consistent with its liquidity profile.[5] Funds with a lower liquidity profile will need to be matched with less frequent opportunities for redemption. The current principles-based approach enables managers to tailor the structure of the fund to the liquidity profile of its portfolio, recognising that **loans as an asset class may be no less liquid than other categories of assets for which no similar rules are proposed**. The automatic imposition of a closed-ended structure regardless of the liquidity of the underlying asset significantly departs from the existing principles-based framework which is designed to be adaptive to these factors and would create significant anomalies between investment strategies without a clear justification.

Furthermore, **other LMTs would be sufficient to manage liquidity risk of loan originating funds**. A closed-ended structure is not the sole means of restricting redemptions. 'Evergreen' loan funds existing in Europe employ a range of robust LMTs to manage liquidity while maintaining an open-ended structure – such as set redemption windows within the year, lock-up periods preventing redemption within a certain period after subscription, and run-off periods, whereby a redeeming investor is repaid only at the end of the loan term. This allows capital to remain fully invested without requiring the fund to be liquidated and relaunched to facilitate redemptions. Furthermore, as outlined above in relation to proposed amendments

[5] See article 46 AIFMR, 'AIFMs shall be able to demonstrate to the competent authorities of their home Member State that an appropriate liquidity management system and effective procedures referred to in Article 16(1) of Directive 2011/61/EU are in place taking into account the investment strategy, the liquidity profile and the redemption policy of each AIF.'

to Article 16, the decision as to how the fund will be structured in terms of frequency of redemptions and an open or closed ended structure is not entirely left to the discretion of fund managers and is in practice subject to the scrutiny and approval of NCAs in order to obtain authorisation for that fund.

This rule may **negatively impact both investors' interests and run counter to the goal of fostering the growth of private equity through loan origination** without market-based evidence to justify a departure from the existing liquidity risk management rules. Investors would be faced with uncertainty as to whether the fund may change to a closed-ended structure where thresholds are exceeded, while it remains unclear as to whether this threshold applies from any single point in time or whether the manager would be afforded a certain period to rebalance the portfolio where the threshold is inadvertently exceeded. More broadly, the business models of a considerable number of existing funds would no longer be feasible in light of this threshold and would be forced to liquidate without providing evidence of any risk or failure caused by these funds.

For retail investors in particular, as mentioned above, EFAMA members have observed an increasing demand for the option to invest in loan funds, notably including products designed to provide debt to social causes, such as supporting small businesses or ESG-related projects (so-called 'impact funds'). However, imposing a closed-ended structure would deter retail investors who largely prefer the ability to exit the fund in case of a change in personal circumstances. Banks, who typically sell fund units to retail investors, also design their distribution systems in favour of open-ended funds and may tend to avoid balanced funds (invested in, for example, a mix of both debt and equity) which may complicate their distribution models. This results in less availability of such funds for the average retail investor and narrows the market for loan funds without clear justification. EFAMA would recommend permitting open-ended structures to be maintained where it is demonstrated that **sufficient measures to manage liquidity risk have been put in place**.

EFAMA RECOMMENDATION

EFAMA would recommend deleting Article 16(2a). As an alternative, we would suggest including wording to the effect that a closed-ended structure would only be required where the AIFM has failed to demonstrate sufficient measures to manage liquidity risk.

4. Retention of 5% of the notional value of loans originated – Article 15(4e)

The new draft directive requires AIFMs to retain, on an ongoing basis, 5% of the notional value of the loans originated and subsequently sold to the secondary market.

EFAMA would in the first instance query the reason for introducing this rule. While similar rules may be considered appropriate in the securitisation context, [6] it is unclear why this requirement should be extended to direct lending by a fund. This 'skin in the game' requirement was introduced for securitisation transactions to combat observed practices of high volumes of low quality loans being originated by banks specifically for the purpose of pooling the loans to sell a repackaged product referencing the loans to investors. Crucially, the requirement to retain the risk in securitisation transactions relates to the note or other product offered to investors and not, directly, to the underlying loans (or other receivables) which have been pooled and repackaged. It is indeed at this issuer-investor level where concerning asymmetries of information justifying risk retention requirements could arise. In contrast, the transfer of a loan, or even a portfolio of loans, made by a fund is not, in practice, characterised by the same asymmetry of information between seller and purchaser. There is none of the potential complexity and opacity introduced by a securitisation

[6] Regulation (EU) 2017/2402.

transaction, with the purchaser able to insist on satisfactory due diligence on the relevant loan(s) before contracting to purchase.

In any event, we are not aware of any notable practice of loans being originated by funds for the purpose of being sold to the secondary market. Indeed, direct lending and other private credit strategies are often characterised by a commitment to the lender-borrower relationship, with credit fund managers actively seeking to protect yields on loans that they intend to hold to maturity – quite the opposite of an 'originate to distribute' model.

Importantly, managers need to have the ability to sell the originated loans to rebalance the portfolio in order to maintain alignment with the investment strategy. Portfolio rebalancing is a core function of the asset manager's portfolio management role, and is necessary to protect investors' interests, for example where the loan is not delivering the required return or no longer meets the required sustainability standards in line with the fund's stated investment objective. This concern is amplified where the terms of the loan allow it to be sold only in its entirety.

We note in the first instance that managers would be required to **adhere to policies in the granting of loans, assessing of credit risk and monitoring their credit portfolio**, as proposed at Article 15(3d). Should any other requirements be considered necessary, these must not disproportionately impinge on the manager's ability to act in the best interests of investors. In this regard, it would be preferable to remove any requirement to retain an economic interest and instead to require a minimum holding period of between 30 to 60 days. Managers should also be permitted to sell any loan where required in the best interests of investors and where the alignment of the interests of investors and assignees can be demonstrated – for example, where the sale is necessary to avoid a breach of the fund's investment rules (including adherence to ESG objectives), or where external circumstances impact the borrower's ability to repay the loan.

EFAMA RECOMMENDATIONS

EFAMA recommends deleting Article 15(4e). Where evidence is shown that there is in reality a risk attached to managers' ability to sell the loans they originate, we would propose replacing the economic interest requirement with a minimum holding period of between 30 to 60 days and including a general exemption for managers to sell any loan where the alignment of the interests of investors and assignees can be demonstrated.

5. Limits to single borrowers of 20% – Article 15(4a)

The draft directive proposes limiting loans to any single borrower who is a financial undertaking or collective investment undertaking to 20% of the AIF's capital. The stated rational is to ensure diversification of risk.

We would suggest that clarification be included that this limit will be calculated **having regard to the ultimate underlying borrower**. This would recognise the growing importance of AIFs in the sphere of micro-financing, whereby AIFs originate loans to a platform lender which in turn provides finance via loans to a multitude of smaller borrowers. While the fund is ostensibly lending to a single borrower, in reality it is exposed to a number of underlying loans to different lenders originated by the microfinance platform, reducing any contagion risks. Microfinancing, whereby small loans are provided to a variety of borrowers such as start-ups and SMEs, represents an important source of alternative funding and has the potential, as recognised in the Explanatory Memorandum, to support job creation, economic growth, innovation, green transition and overall economic recovery.

In addition, it must be recognised that funds may be subject to a ramp up period or drawdown structures, whereby capital of a certain amount is committed by investors and drawn down over the life of the fund. It should therefore be clarified that the capital of the AIF refers to the target size of the AIF or to the

commitment of its investors and that this 20% limit does not apply during the ramp-up period of the fund, as defined by the manager. We would also note that loans originated between funds within the same group would not give rise to broader contagion risks.

EFAMA RECOMMENDATIONS

As noted above, EFAMA recommends against the introduction of product-specific rules. Where such a rule is nonetheless determined to be necessary, EFAMA recommends amending Article 15(4a) to specify that this limit shall have regard to the ultimate underlying investors, as well as amending Article 15(4b) to specify that the limit shall not apply during the ramp-up period of the fund. EFAMA recommends including a definition of 'AIF's capital' which shall have reference to the target size of the AIF or to the commitment of its investors.

III. Supervisory reporting

Policy Recommendations

1. Amendments to AIFM Reporting – Article 24 and 69b

EFAMA welcomes an initiative whereby supervisory data would be collected in a method which reduces duplication and inconsistencies between reporting frameworks to which asset managers are subject. In particular, we would support the efficient sharing between competent authorities of data already reported to them by fund managers under EU reporting frameworks.

Feedback received from EFAMA members has indicated that management companies are often required to send various sets of data to a variety of public authorities – for example, NCAs, NCBs, ESRB and ECB. Ad hoc requests received by fund managers during the outbreak of the Covid-19 pandemic from these various authorities unfortunately illustrated the lack of coordination between these authorities, leading to unnecessary duplication and additional pressure on teams responding to the crisis. Enhanced sharing of data between NCAs, NCBs and other securities regulators at the national and EU levels at Level 2 or 3 would reduce the supervisory burden on management companies and ultimately reduce costs for investors. Notably, NCAs should be granted access to the data collected by central banks from fund managers through fund inventories, as well as making use of funds' annual and semi-annual reports.

We look forward to providing input into ESMA's report under Article 69b(2) of the proposed directive in order to assist in identifying means of easing the operational burden on asset managers. As mentioned, EFAMA would emphasise that **resort must first be had to the efficient exchange of data between authorities before considering changes to the reporting requirements for asset managers**. Changes to the template would result in significant cost implications in terms of data sourcing, aggregation, editing XML, to name a few, which should be balanced with the value which any changes would add.

Where change is proposed to be made to the reporting requirements for asset managers under Annex IV of the AIFM Regulation (**AIFMR**), we would stress that the reporting template be tailored to focus on the collection of data which is of particular relevance to **meaningfully assessing any broader risk presented by the fund in question**. We would caution against the expansion of data to be reported, noting that the breadth of data presently sought may not be appropriate for all alternative investment funds and further data will require a greater dedication of a fund's resources in terms of time and cost factors without necessarily providing greater benefit to regulators.

2. Introduction of UCITS Reporting – Article 20a and 20b

The new proposal seeks to introduce reporting for UCITS, similar to that applicable to AIFMs at present. We would highlight that this would be a new requirement for UCITS management companies, requiring significant resources to implement.

EFAMA would assert that focus should first be given to the AIFMD review before considering whether to introduce a similar regime for UCITS. At present, there exist a number of national regimes in place which would over-complicate the review process.

It should be recalled that supervisory reporting was introduced in the AIFMD in order to aid in the monitoring of systemic risk and because the AIFMD was not designed to regulate products themselves. In contrast, the UCITS Directive sets out rules regulating the UCITS funds themselves, which are therefore subject to a comprehensive set of strict requirements as regards their exposure limits, borrowing eligible assets, among other items, and as such represent a lesser risk to the financial system. It should also be recognised that much of this data is periodically reported already to NCBs by way of fund inventories, and as such the proposed review under Article 20b should first ensure the efficient sharing of data between these authorities before determining whether a separate reporting regime is necessary under Article 20a.

As such, EFAMA would suggest an amendment should be included in Article 20a providing that this obligation to report applies **to the extent this data has not already been reported under another reporting framework**, in light of the goal of reducing duplicative reporting under Article 20b.

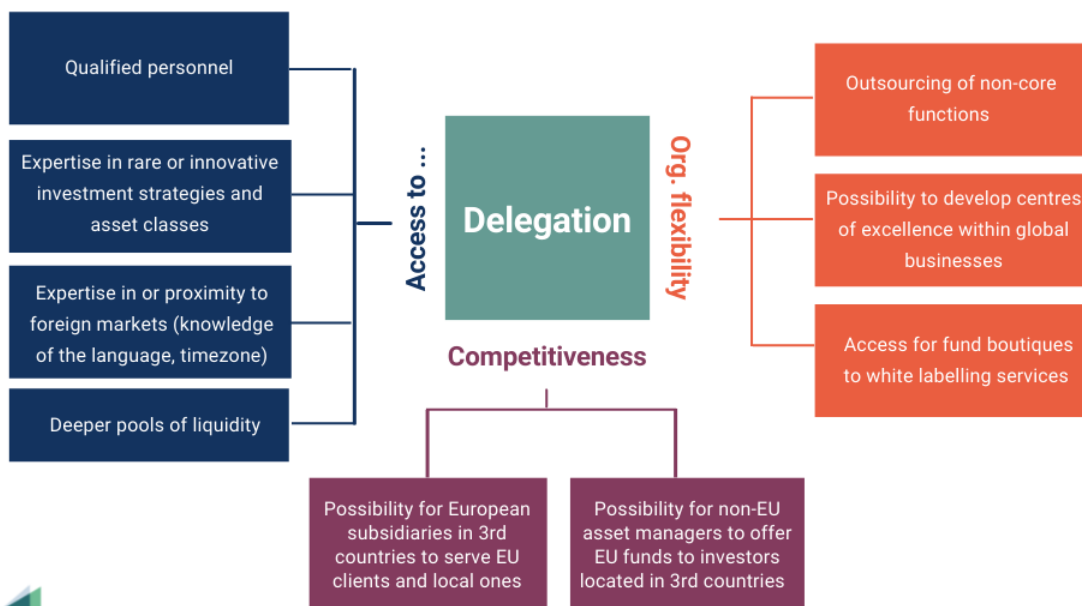
IV. Delegation

As delegation of investment management functions is of primary importance to the fund sector, EFAMA welcomes the decision taken by the Commission, after extensive consultations, to limit its proposal on delegation to a few targeted amendments, although we remain unconvinced that changes in the current framework are necessary.

EFAMA welcomes in particular the recognition by the Commission that delegation “allows for the efficient management of investment portfolios and for sourcing the necessary expertise in a particular geographic market or asset class” and that the delegation framework “contributes to the success of the EU fund and manager labels”.

Benefits form delegation

Delegation plays indeed a capital role in the asset management industry as it allows, among other things, management companies to access outside expertise and organise their operations more efficiently, translating ultimately into lower-cost and more diversified products for individual and professional investors alike. The graph below summarises the key attributes of delegation in our industry.



A comprehensive regulatory framework

Delegation is, moreover, already extensively regulated under the AIFM Directive/AIFMR, as well as under UCITS, although to a lesser extent. In practice, however, supervisors have indeed tended to apply the more detailed requirements of the former also to the latter. The fund delegation regime requires asset managers to:

i. have an appropriate due diligence process when selecting a delegate,

ii. draw legal arrangements that clearly specify the delegate's obligations, as well as the applicable regulatory standards,

iii. notify their competent national authority before the entry into force of the delegation arrangements, and

iv. regularly monitor the activities delegated to ensure that they are conducted in line with the investment strategy, the fund risk profile, as well as the applicable regulatory standards.

Most importantly, **delegation does not undermine the supervision of the delegated activities** as the national competent authority will always retain the power to request additional information on the said activities from the delegating management company or from the delegate's direct supervisor. It may also, in cooperation with the delegate's supervisor, conduct supervisory actions such as on-site visits, examinations, et al., where necessary. In this respect, one should recall that the existence of a cooperation agreement between the supervisor of the delegee and that of the delegate is a necessary pre-requisite under the AIFMD for delegation arrangements to non-EU entities to be authorised.

Policy recommendations

1. **Absence of evidence**

There is presently **no clear evidence that delegation, as it is currently regulated in the EU, represents a threat to end-investors or the financial system more broadly**. Since 2017, national competent authorities have discussed more than 250 delegation cases as part of the ESMA's Supervisory Coordination Network (SCN), with discussions on this topic continuing within the ESMA's Operational Working Group (OWG). Yet, despite the breadth of these consultations, little concrete evidence has so far been presented to demonstrate and quantify any risks associated with (extra-EU) delegation. On the contrary, these discussions have further highlighted that an appropriate balance is already in place between ensuring access to high-quality services for end-investors while ensuring that proper monitoring and oversight are carried out by the delegating management company. We understand, nevertheless, that the risk of divergences in the way the existing delegation provisions are being interpreted and applied by some national competent authorities has driven discussions between supervisors in this area.

2. **Substance requirements – Articles 8(1c) AIFMD / 7(1b) UCITS**

EFAMA would like to highlight that **these requirements should be considered as a "stepping stone"**. The actual substance requirements applying to delegating management companies are determined jointly in discussions with their regulators and are ultimately imposed by the latter based on several parameters which are likely to evolve in the course of time, e.g. the specific business model and activities of the entity seeking an authorisation, the complexity of its business, the nature of the delegate, its specific jurisdiction, etc. We recommend to remove the reference to "full-time employees" or to substitute this term by "2 full-time equivalents" to allow for greater organisational flexibility, especially for multi-strategy asset managers that require a larger breadth of expertise.

EFAMA RECOMMENDATIONS
EFAMA recommends amending Article 8(1c) to clarify that the minimum substance requirement is "2 full-time equivalents" rather than "2 full-time employees".

3. **Activities subject to delegation rules – Art. 20(1) AIFMD / 13(1) UCITS)**

EFAMA welcomes the clarifications brought by the European Commission as regards the scope of the delegation regime. We would furthermore suggest to clarify in the recitals that **AIFMD/UCITS delegation rules only apply when an asset manager is legally responsible for a given function**. Delegation rules should not apply to a management company when the responsibility for a function is contracted to a third-party services provider for instance in charge of administrative, operational, IT, or other functions. Similarly, distribution by an independent party should not be considered as a delegation of the marketing functions. A management company should therefore not be held responsible for the actions of a distributor, whether a financial advisor, an insurance company, or a bank, when the latter acts on its own account. In general, the scope of the delegation regime should not include all actors involved in an asset management company's value chain, but solely limited to those tasks for which the management company bears direct responsibility (i.e. the investment management functions).

EFAMA RECOMMENDATIONS
EFAMA recommends amending the recitals to specify that delegation rules should only apply to tasks for which the management company bears direct responsibility.

4. NCAs reporting to ESMA – Article 7(5) AIFMD / 13(3) UCITS

EFAMA understands that greater transparency is required to enhance trust between NCAs in the application of the current delegation regime. Legislative amendments should however clearly specify that the underlying rationale for the NCAs to report delegation arrangements to ESMA is to address supervisory divergences among Member States. Furthermore, NCAs should be allowed to take into account qualitative considerations when determining which arrangements ought to be reported to ESMA, so as to avoid a single quantitative threshold, if any.

As a starting point, the amended legislation should clearly state the **objective pursued by the reporting regime** under consideration: the information reported to ESMA should be used to inform the ESMA peer-reviews foreseen in Article 38a of the AIFMD. In no case should the reporting regime directly or indirectly empower ESMA to analyse individual delegated arrangements it receives, as this may be deduced from Articles 7, paragraph 5, point (e) AIFMD / 13, paragraph 3, point (e) UCITS.

The **focus on extra-EU delegation** in the reporting regime should also be properly justified, taking into consideration that extra-EU delegation does not entail more risk for end-investors than intra-EU delegation. In addition to the general delegation rules outlined in the introduction to this section on delegation, we recall that extra-EU delegation can only take place when: (a) there is a supervisory cooperation arrangement with the relevant 3rd country supervisor; and (b) there is a legal agreement between the EU management company and the non-EU delegate, which specifies their respective obligations, as well as the applicable EU regulatory standards. Management companies that delegate outside the EU maintain, moreover, a strong level of control and oversight over their delegates to guarantee that the latter respect the fund's investment strategy, risk profile, and applicable regulatory standards.

The **quantitative threshold** foreseen by the European Commission – i.e., the determination whether an asset manager delegates more portfolio or risk management than it retains – should be complemented by qualitative considerations. First, these qualitative considerations would help address the fact that quantifying the level of delegation is a particularly difficult endeavour. All functions do not represent the same level of importance and complexity. Furthermore, the importance of a function may change from one fund to the other. The risk management function would, for instance, be more important for a fund that invests in complex alternative strategies than for a fund that invests in "plain vanilla" and long-only securities such as equities. Second, these qualitative considerations would allow to reduce the administrative burden on national supervisors by limiting the notifications to ESMA to the delegation arrangements that are the most relevant for supervisory discussions at ESMA-level. NCAs could, among other things, take into account the investment strategy pursued by the fund and the actual level of control and oversight retained over the delegate, reducing the reporting to ESMA to fewer and very concrete cases.

It should also be made clear that when reporting delegation arrangements involving delegates outside the EU, additional distinctions related to intra-group vs. extra-group delegation are not made material, provided the relevant rules are applied uniformly, regardless of whether the delegate is an affiliate entity.

The mandate empowering ESMA to specify the **content and procedure of the NCAs delegation notifications** (see Art. 7(8) AIFMD / 13(4) UCITS) should be framed in such a way to avoid a situation where the RTS would lead to undue additional administrative burden for all the parties involved. The content of the NCAs reporting notifications should not be as extensive as to force NCAs to request additional information from asset managers considering the already extensive information reported to NCAs when delegations are originally authorised. Such notifications should nonetheless include qualitative information on the delegation oversight policies to ensure that supervisory discussions within ESMA do not focus on quantitative considerations alone (i.e. the extent to which asset managers delegate portfolio and/or risk management to third-party services providers compared to how much they choose to retain). Moreover, NCAs should only report those delegation arrangements that have been authorised after the entry into

effect of the amended AIFMD requirements, or those to be updated on the back of (supervisory) developments in the previous year. An appropriate grandfathering clause would therefore avoid that NCAs have to report all the past delegation arrangements they have authorised.

Lastly, co-legislators should consider to limit the life of this reporting regime to a five-year period, the time that ESMA collects all the information it needs to ensure supervisory convergence between Member States. EFAMA would not see the prolonged benefits of this regime once supervisory convergence is achieved, as (limited) divergences between NCAs have been the only justification for a review of the existing delegation regime.

EFAMA RECOMMENDATIONS

EFAMA recommends amending the recitals to clarify the objective pursued by this reporting regime as well as amending Article 7(5) to ensure that NCAs can take into account qualitative criteria when determining which arrangements to report to ESMA. The content of the delegation notifications should not be as extensive as to require additional reporting from asset managers to ESMA.

Reviews of the delegation regime (Article 38a AIFMD/101a UCITS)

EFAMA is very supportive of supervisory convergence and acknowledges that there may be certain delegation areas, such as the treatment of intra-group delegation, where additional convergence could be achieved. We strongly question, however, the appropriateness to decide in a Level 1 text ESMA's course of action for the following reasons: a) ESMA should remain a risk-based supervisor; b) peer-reviews represent an important charge for NCAs and industry players alike; c) ESMA has already launched a peer review on delegation in 2021 and will launch a second one in 2023.

EFAMA RECOMMENDATIONS

EFAMA recommends deleting Article 38a, or at least, deleting from the said article any reference to a precise frequency. Peer reviews are resources-intensive exercises and it may take several years for ESMA to integrate the findings made during the first peer review.

V. Depositary Services

1. Depositary passport

Based on its impact assessment study, the European Commission has concluded that introducing a depositary passport was premature in the absence of further EU harmonisation of securities and solvency laws. However, as a result of poor supply of depository services in some concentrated markets, the draft proposal introduces a temporary clause that permits NCAs to select a depositary service established in another Member State, accompanied by increased supervision.

Despite such transitional provision, EFAMA welcomes the decision of the European Commission to not introduce a depositary passport, believing that the requirement for the depositary to share the same domicile as the fund is an essential safeguard for investor protection. Such provision guarantees legal certainty and swift means of redress for investors in case of a loss. At the same time, the proximity between the depositary and the fund facilitates activities such as safe-keeping, oversight and cash monitoring duties, communication with the fund's manager and respective authorities. The latter also benefit as they can carry out supervisory mandates – inspections, examinations or investigation of any misconduct - in a more efficient way.

With regards to the transitional provision, it is worth noting that the wording of the revised Article 61 paragraph 5 seems to provide full discretion to the NCAs of any Member State to approve the appointment of a depositary in another Member State. In order to ensure consistency with the rationale behind the derogation provision established by the draft proposal, the revised Article 61 should be amended to guarantee that such provision is used only in the Member State where it is proven that there is a shortage of depositary service offers.

2. Central securities depositories (CSD)

EFAMA strongly supports the proposed changes as there are currently no provisions in the CSDR that ensure a liability regime for CSDs on par with that available under the UCITS and AIFMD frameworks. The liability gap between CSDs and depositary becomes prominent when certain types of CSDs ("investor" CSD) provide custody in relation to securities that are initially issued by another CSD ("issuer" CSD) which is operating purely as a Securities Settlement System (SSS)[7]. In doing so, the former become intermediaries in the fund's asset holding chain and offer services in direct competition with those provided by UCITS/AIF funds' depositaries. As such, they should consequently become subject to the same liability standards applying to a fund depositary, or to any of its third-party delegates, in cases where assets are lost or in instances where the negligence or misconduct of the "investor" CSD agent are proven. We would recommend for the final text of the revised AIFMD to preserve the references to the two different types of CSDs, as in the Delegated Regulation (EU) 2017/392 of 11 November 2016.

VI. Disclosure to investors

The AIFMD draft proposal amends the requirement related to the information flow between the AIFMs and AIF investors in order to improve transparency: the revised draft establishes that the AIFM must disclose additional information, namely the conditions for using LMTs and the related fees (direct or indirect) borne either by the AIFM (or its affiliates) or by the AIF.

EFAMA believes that the existing disclosures through UCITS, PRIIPs and MiFID legislations are already sufficient and allow investors to make informed investment decisions. Adding a new set of rules would only create confusion and complicate fund managers' task to articulate these various sources of requirements. In addition, it is crucial to keep in mind that an AIFM needs the necessary flexibility in order to tailor the information provided to the specific needs of its investors. Mandatory retail investor-type disclosure – as established by MiFID – might lead to the situation where non-relevant information is disclosed to professional investors.

With regards to the amended Article 23 (1) (ia), which requires the disclosure of "*a list of fees and charges that will be applied in connection with the operation of the AIF and that will be borne by the AIFM or its affiliates*", we understand that it will be required to list the different categories of fees and costs. It is worth mentioning that the AIFM does not have any power over the fees and costs charged by its affiliated companies. In addition, what is key for investors is what they are charged for, i.e. costs borne by the fund, and investors have no linkage with the costs borne by the fund managers themselves (which are part of the normal confidential business activities of the managers).

Additionally, with regards to the revised Article 23 (4) (d) and its requirements on the disclosure of originated loan portfolios, we are of the view that only the aggregate amount of the originated loan portfolio should be disclosed – and not individual names of borrowers. Moreover, on reporting fees and charges – Article 23 (4) (e) – we note that when it comes to reporting on specific illiquid and complex fund structures (such as real asset funds), a granular reporting would be a very difficult exercise. EFAMA suggests that investors

[7] For a definition of "issuer" versus and "investor" CSD, please refer to Article 1 (respectively letter e. and f.) of the Commission Delegated Regulation (EU) 2017/392 of 11 November 2016.

rely on the disclosure of a maximum number of fees, including a disclaimer indicating that more might be charged under specific circumstances. At the same time, we would like to emphasise that the proposed frequency (quarterly reporting) is not appropriate, as every three months, the calculation of fees would be based on estimates, with little or no value for investors.

Finally, in order to avoid misinterpretations, we would welcome further clarity around the following wordings:

- "to any of its investments": Article 23 (e)
- "the staff of the AIFM": Article 23 (f)
- "charged or *allocated*": Article 23 (e)

We suggest deleting the reference to charges and fees in order to avoid adding new provisions which might be inconsistent in relation to the relevant PRIIPs, UCITS and MiFID provisions on this topic.

VII. Grandfathering / Transitional provisions

EFAMA notes that a number of the proposed amendments will need to incorporate appropriate grandfathering provisions to enable managers to transition to the new rules once enacted. Such is important to protect the legal expectations of investors who subscribed to the fund prior to the entry into force of the new proposed amendments, as well as to avoid the retroactive effect of the amendments.

We would also note that the operation of a number of the provisions rely on the subsequent enactment of delegated acts. To ensure a consistent and uniform application of the rules, we would suggest that it be specified that those provisions come into effect after the publication of the final level 2 and 3 texts to allow sufficient time to review and align practices with these technical clarifications. For example, loans originated by funds typically have a term of a number of years. For legal certainty, it should be specified that any new rules applying to loans originated on or after the rules' entry into force should not have a retroactive effect in relation to loans previously entered into. The merit of such grandfathering provisions was noted by ESMA in its 2016 Opinion on loan originating funds.[8]

Similarly, amendments will need to be made to the terms of the fund's shares and rules in order to update provisions regarding the use of specific LMTs. Managers will need the opportunity to review the delegated acts which are to be enacted specifying the characteristics of the LMTs and the circumstances in which managers may activate the same.

EFAMA RECOMMENDATIONS

EFAMA recommends including a new provision be included to the effect that the provisions related to loan funds do not apply to AIFMs in so far as they manage AIFs of the closed-ended type whose subscription period for investors has closed prior to the entry into force of this Directive nor to loans originated prior to the entry into force of this Directive.

We would recommend Article 3 of the proposed Directive be amended to state the Directive shall apply from 12 months after the date of entry into force of the Directive or, where relevant, of the entry

[8] ESMA, 'Key principles for a European framework on loan origination by funds' (11 April 2016) at paragraph 29, available at https://www.esma.europa.eu/press-news/esma-news/esma-publishes-opinion-eu-framework-loan-origination-investment-funds.

into force of the relevant delegated acts and implementing technical standards applicable to the provisions on liquidity risk management and supervisory reporting. Namely:

- Articles 16(2b) and (2c) AIFMD shall apply 12 months after the date of adoption of the delegated acts referred to under Articles 16(2f) and (2g) AIFMD;

- Article 24(1) AIFMD shall apply 12 months after the date of adoption of the delegated act referred to under Article 24(6) AIFMD and the implementing technical standards under Article 24(7) AIFMD;

- Article 18a(1) and (2) UCITSD shall apply 12 months after the date of adoption of the delegated acts referred to under Articles 18a(3) and (4) UCITSD;

- Article 20a UCITSD shall apply 12 months after the date of adoption of the delegated act referred to under Article 20a(2) and the implementing technical standards under Article 2a(3) UCITSD.

- Lastly, concerning the reporting of delegation agreements to ESMA by NCAs – as per Article 7(5) and (8) of the Commission's proposal – we believe that NCAs should only report those delegation arrangements that have been authorised after the entry into effect of the amended AIFMD requirements, or those to be updated on the back of (supervisory) developments in the previous year. An appropriate grandfathering clause would therefore avoid that NCAs have to report all the past delegation arrangements they have authorised.

VIII. Public consultation

A number of key provisions within the proposal are subject to further specification by way of regulatory technical standards to be developed by ESMA. EFAMA welcomes this approach as it allows for optimum participation of relevant stakeholders to best inform the development of the rules. Industry involvement at that stage will be particularly critical given that the proposal aims to improve upon rules which are core to EU fund regulation. For example, as regards the report to be prepared by ESMA under Article 69b(2) for the development of an integrated supervisory data collection process, we would recommend that technical experts from the industry and NCAs be given a key role, perhaps via the setting up of an expert group on supervisory reporting to best inform the preparation of this report.

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ABOUT EFAMA

EFAMA is the voice of the European investment management industry, which manages over EUR 30 trillion of assets on behalf of its clients in Europe and around the world. We advocate for a regulatory environment that supports our industry's crucial role in steering capital towards investments for a sustainable future and providing long-term value for investors. More information available at www.efama.org.

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