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IMPACT ASSESSMENT REPORT

Accompanying the

Proposal for a Directive of the European Parliament and of the Council

amending Directives 2011/61/EU and 2009/65/EC as regards delegation arrangements, liquidity risk management, supervisory reporting, provision of depositary and custody services and loan origination by alternative investment funds

{COM(2021) 721 final} - {SEC(2021) 570 final} - {SWD(2021) 341 final}

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GLOSSARY

Assets under management (AuM): is the total market value of the investments that a fund manager manages on behalf the fund.

Collective Investment Undertaking (CIU): is a legal structure to pool capital and hold collective investments. It usually has no economic life on its own; the key decisions in relation to the management and marketing of a CIU are taken by a fund manager of the CIU. CIU span a wide range of legal structures, including closed and open-end funds and partnerships.

Alternative Investment Fund (AIF): is a CIU defined by the EU law as raising capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors and does not require authorisation pursuant to Article 5 of Directive 2009/65/EC (UCITS Directive).

Alternative Investment Fund Manager (AIFM): is responsible for the management of AIFs. Typical tasks include, for example, picking investments, managing risks of the composed collective investment portfolio, monitoring third entities to which AIFM delegated certain functions and providing investor disclosures.

Alternative Investment Fund Managers Directive (AIFMD): was voted into EU law in 2011 and entered into application in July 2013. This Directive governs authorisation and supervision of AIFMs in the EU and lays down organisation and operation requirements for AIFMs.

Alternative Investment Fund Managers Regulation (AIFMR): it supplements the AIFMD, including detailed supervisory reporting requirements by AIFs.

Alternative Investment Management Association (AIMA): is the global representative of the alternative investment industry.

Capital Market Union (CMU): is a plan of the European Commission to create a single market for capital. The aim is to get money – investments and savings – flowing across the EU so that it can benefit consumers, investors and companies, regardless of where they are located.

Competent authority: means the national authorities of a Member State, which are empowered by law or regulation to supervise AIFMs and/or AIFs.

Central securities depositories (CSDs): as a part of the post-trade infrastructures CSDs operate securities settlement systems, participate in controlling the integrity of an issue hindering the undue creation or reduction of issued securities and are involved in securing collateral for monetary policy operations as well as in securing collateral between credit institutions. CSD also hold securities of their participants.

Central Securities Depositories Regulation (CSDR): is an EU Regulation No 909/2014 of 23 July 2014 governing activities of CSDs and improving securities settlement in the Union.

Custodian: an entity that safe-keeps investment funds' assets, which are financial instruments, often a credit institution, an investment bank or a central securities depository.

Depositary: an entity, often a credit institution, which besides safe-keeping investment funds' assets, has other oversight duties such as monitoring cash flows and compliance with fund rules.

European Long-term Investment Funds (ELTIF): is an EU regulated CIU, which allows professional and retail investors to invest into companies and projects that need long-term capital.

European Funds and Asset Managers Association (EFAMA): is a pan-European organisation that represents the European investment management industry towards European policymakers.

Environmental, social, and corporate governance (ESG): this refers to the three central factors in measuring the sustainability and societal impact of an investment in a company or business.

European Securities and Markets Authority (ESMA): ESMA is an independent EU Authority that contributes to safeguarding the stability of the European Union's financial system by enhancing the protection of investors and promoting stable and orderly financial markets. It achieves this by assessing risks to investors, markets and financial stability, completing a single rulebook for EU financial markets and promoting supervisory convergence.

Gross notional exposure (GNE): is the sum of all the absolute value of all fund's positions, a leverage –related measure to be reported under the AIFMR.

Home competent authority: refers to the competent authority of the Member State where an AIFM is domiciled or authorised/registered.

Host competent authority: refers to the competent authority of the Member State where an AIF is marketed and which is other than the Member State where the AIFM or AIF is domiciled or authorised/registered.

Key Information Document (KID): refers to the document under the PRIIP Regulation, containing the key information necessary for retail investors to make an informed investment decision and compare different investment products.

Liquidity Management Tools (LMTs): refers to the tools asset managers can use to manage liquidity risks in open-ended investment funds.

Loan originating fund (LOF): refers to an AIF that - provides credit by acting as the sole or primary lender, participates in loans through purchases on the secondary market and/or participates in loan restructuring for indebted borrowers.

Directive on Markets in Financial Instruments (MiFID): is a Directive, which is a cornerstone of the EU regulation of financial markets conceived in 2004 with an effect from 2007. It governs the provision of investment services in financial instruments by banks and investment firms and the operation of traditional stock exchanges and alternative trading venues.

MiFID II: in 2011, the European Commission issued a MiFID amending proposal, which led to the adoption of MiFID II. This new law entered into force in January 2018.

Regulation on Markets in Financial Instruments (MiFIR): is the Regulation on markets in financial instruments complements MiFID II. It was voted into law on 15 May 2014.

Money markets funds (MMFs): are open-ended investment funds that provide short-term finance to financial institutions, corporations and governments. They provide a high degree of liquidity, diversification and stability of value of the principal invested, combined with a market-based yield. In the Union activities of MMFs are governed by Regulation of 14 June 2017.

Net Asset Value (NAV): value of a fund's total assets, minus its liabilities. The NAV per share is used to determine prices available to investors for redemptions and subscriptions.

Open-ended fund: is a CIU, which can issue and redeem shares at any time. Investors can buy or sell shares directly from the fund.

Undertakings for Collective Investment in Transferable Securities (UCITS): is an open-ended, standardised CIU, which predominantly invests in transferable securities and available to retail investors. A UCITS and its manager must be established in the EU.

UCITS Directive (UCITSD): is the main European framework covering retail collective investment schemes. The first UCITS Directive was adopted in 1985, and since then the framework has continuously evolved. The last amendment took place in 2014 with the UCITS V Directive, where the depositary regime was clarified and strengthened. The UCITS Directive is seen as the benchmark for retail investment funds, as the Directive imposes a strict investment portfolio diversification and restricts eligible assets to transferable securities in order to ensure that retail investors can easily redeem their investment.

1. INTRODUCTION

The Alternative Investment Funds Manager Directive (AIFMD) was first adopted in 2011 to establish a regulatory framework covering the activities of the Alternative Investments Fund (AIF) sector. It was designed as part of the policy response to the global financial crisis that exposed weaknesses and vulnerabilities in certain fund activities that could amplify risks to the broader financial system and to investors following the consensus among G20 Leaders that all sectors of the financial industry should be better regulated and supervised.[1] In support of the G20 objectives the International Organization of Securities Commissions (IOSCO) issued high-level principles for hedge funds regulation to guide the development of international standards in this area.[2]

Following the European Council's[3] endorsement of Europe's international commitments, and in the light of the European Parliament report[4], the European Commission (hereinafter - 'Commission') issued a legislative proposal for a regulatory framework governing Alternative Investment Fund Managers (AIFMs).[5] The AIFMD was adopted on 8 June 2011. Following its transposition into national legal systems, the AIFMD entered into application on 22 July 2013.[6]

As a post-crisis regulatory initiative, the AIFMD seeks to achieve a coherent supervisory approach to the risks that the activities of AIFs may generate or transmit to the financial system, to provide high-levels of investor protections while also facilitating EU AIF market integration.[7] AIFMs are required to effectively manage risks and ensure adequate transparency regarding the activities of their managed AIFs and in return, are able to manage and market AIFs to professional investors across the Union with a single authorisation from their home supervisor.[8] The Evaluation annexed to this impact assessment (Annex 9) concludes that the AIFMD has largely met its objectives.
The investment fund sector has roughly tripled in size since 2008, from EUR 5.5 trillion assets to more than 15 trillion assets (figure 1), and its assets as a percentage of total financial sector assets have also grown significantly.[9] It has interconnections with the broader the financial sector (e.g. by providing wholesale funding to banks), making it

[1] Declaration of the Summit on Financial Markets and the World Economy, Washington DC, November 15, 2008.
[2] Recital 89 of the AIFMD; IOSCO Final Report Hedge Funds Oversight, June 2009.
[3] Conclusions of the European Council of 16 September 2010.
[4] Report of the European Parliament with recommendations to the Commission on hedge funds and private equity (A6-0338/2008) ['Rasmussen' Report] and on the transparency of institutional investors (A6-0296-2008) ['Lehne' Report]; Report of the High - Level Group on Financial Supervision in the EU, 25 February 2009, p. 25.
[5] Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers, 30.04.2009, COM (2009) 207 final.
[6] The last Member State transposing the AIFMD completed this process by the end of 2015.
[7] Recitals 2 - 4 and 94 of the AIFMD.
[8] Article 32(1) of the AIFMD.
[9] Source: ECB SDW. In 2008, the assets of euro area investment funds were about 13% of total financial sector assets, compared to almost 20% in 2020 (source: ECB Macroprudential Bulletin April 2021).

important to manage potential systemic risks appropriately.[10] At the same time, it is important to ensure that the AIFMD does not impose unnecessary costs on fund managers in the context of globally competitive financial markets and where such costs can affect fund fees and investor returns. The fund sector has an important role to play in the pandemic recovery as a channel for financing of the real economy, supporting economic growth, innovation and employment.

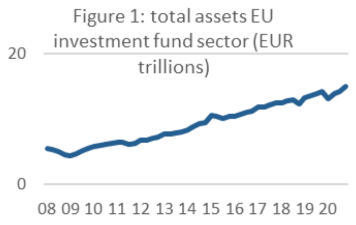

Figure 1: total assets EU investment fund sector (EUR trillions)

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The AIFMD contains rules on conflicts of interest, disclosure and transparency requirements to protect investors, which is beneficial for building confidence in EU financial markets and supporting the flow of capital to investments in the economy. Rules governing valuation, which is necessary for establishing each investor's share in a given AIF and for monitoring the AIF's performance, have increased discipline and structure in the asset valuation process.

The AIFMD homogenizing depositary liability and functions, such as the safekeeping of AIF assets and fund oversight, and requiring that each fund appoints a depositary further enhanced investor protection. It is a requirement that for EU AIFs the depositary must be located in the same Member State as the fund, which has led to a fragmented landscape of depositary services in Europe. Nevertheless, the depositary regime can be credited with supporting the orderly functioning of the investment funds market and its integrity.

The AIFMD introduced tools for improved macro-prudential monitoring and supervision of financial stability risks. AIFMs are required to report on the main AIF exposures, their liquidity profile and leverage. While the granularity of the reported data could be improved, this information has supported effective macro-prudential supervision and can help identify and mitigate potential financial stability risks. For example, the European Securities and Markets Authority (ESMA) aggregates supervisory reporting data and publishes Annual Statistical Reports on EU AIFs, which provide market participants, investors as well as supervisors and policy makers with information on market developments.[11] Supervisory reporting is of outmost value in times of market stress.

The onset of the COVID-19 pandemic resulted in a real life stress-test with markets experiencing significant turmoil and liquidity constraints during 2020. This led central banks to intervene to stabilise markets and provide market liquidity. Certain fund types, such as property funds, experienced difficulties given the illiquid nature of their underlying assets combined with open-ended fund structures where particular issues

[10] See e.g. ESRB NBFI Monitor 2020, p. 59, 62-63. https://www.esrb.europa.eu/pub/pdf/reports/nbfi_monitor/esrb.202010_eunon-bankfinancialintermediationriskmonitor2020~89c25e1973.en.pdf?588be9e8391cfb17584d2a283dfe0abe

[11] ESMA Annual Statistical Report EU Alternative Investment Funds 2019, 21.01.2019, ESMA 50-165-748.

arose with obtaining accurate asset valuations.[12] Funds investing in high-yield (HY) and emerging markets (EM) bonds, which are also less liquid assets, similarly faced significant liquidity pressure following increased redemption requests.

The figures and trends reported as of 13 of May 2021 indicate that the European investment fund sector has, in general, weathered the COVID-19 storm quite well. The total net asset value (NAV) of funds that activated a liquidity management tool (LMT) for EU and EEA AIFs was €5.57bn. Regarding AIFs, suspensions of redemptions reported by NCAs amounted to €2.34bn unchanged from the previous iterations.[13] There were only 56 AIFs[14] out of 30,357 EU AIFs[15] liquidated or entering into liquidation during the COVID-19 crisis.[16] Besides managing liquidity risks, which may have an impact on the entire financial system, AIFMs are also mainstreaming sustainability into their risk management processes.

The EU is determined to address climate/sustainability risks and is finalising the adoption of a range of measures applicable to financial intermediaries. The Sustainable Finance Disclosure Regulation (SFDR), which covers asset managers like AIFMs, seeks to increase awareness of adverse sustainability impacts and reliability of financial products claiming to pursue sustainable investing.[17] AIFMs are set to play an important role in creating a more ESG-embedded investment culture by taking into account longer-term developments linked to ESG when assessing potential investments. The effectiveness of the ESG-related measures will be assessed in the future, whereas this Staff Working Document tackles the issues brought up by the backwards-looking analysis of the functioning of the AIFMD.

The AIFMD contains a review clause that mandated the Commission to start assessing the scope and functioning of this legal framework by July 2016, and to present a report to the European Parliament and Council.[18] Drawing on the extensive preparatory work involving an external contactor conducting a general survey and producing an evidence-based study on the effectiveness of the AIFMD[19], the Commission submitted a report to the EU co-legislators assessing the application and the scope of the AIFMD (AIFMD Report)[20] on the 10 June 2020. The AIFMD Report assessed the impact of the AIFMD on investors, AIFs, AIFMs in the Union and in third countries, establishing the degree to which the objectives pursued by the AIFMD have been achieved. An accompanying Staff

[12] Open-end fund (or open-ended fund) is a collective investment scheme that can issue and redeem shares at any time. These property funds were based in the UK and a few in Ireland.
[13] ESMA 20 of May 2021 Report on the use of by UCITS/AIFs/MMFs. It includes information pertaining to marketing of funds in EU28 and EEA Member states.
[14] 49 in Austria, 1 in France, 2 in the Netherlands and 3 in Ireland. This data is based on the NCA reporting to ESMA.
[15] ESMA Annual Statistical Report EU Alternative Investment Funds 2020, 10 January 2020 ESMA50-165-1032.
[16] For example, due to liquidity issues, valuation problems and/or significant outflows.
[17] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability- related disclosures in the financial services sector; OJ L 317, 9.12.2019, p. 1–16.
[18] Article 69 of the AIFMD.
[19] Report on the Operation of the Alternative Investment Fund Managers Directive (AIFMD) - Directive 2011/61/EU, retrieved from: [https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/190110-aifmd-operation-report_en.pdf] (KPMG Report, December 2018).
[20] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52020DC0232

Working Document provides more detail of the assessment provided in the AIFMD Report.[21] Finally, an Evaluation of the AIFMD was completed as documented in Annex 9 of this impact assessment.

The AIFMD Report, Evaluation and stakeholder feedback highlighted specific areas where targeted improvements could be made to the AIFMD regulatory framework and identified regulatory gaps that could be addressed. These are (i) fragmented market for loan-originating AIFs, which also raise potential risks to financial stability; (ii) fragmented market for depositary services; (iii) diverging interpretation of delegation regimes under AIFMD and UCITS; (iv) constrained liquidity risk management by the managers of open-ended investment funds; (v) inadequate data reporting for market monitoring and (vi) unequal treatment of custodians of AIFs' assets. The sections below describe the problems that these regulatory gaps create offering a range of policy options that were assessed to determine the best way forward.

Section 2 explains the market and regulatory developments that have led to the issues that have emerged since the Directive entered into force and discusses the problem drivers and the consequences for financial stability, the efficiency of the investment fund market and overall investor protection.

Section 3 explains why it is necessary for the European Union to address these issues directly instead of the individual Member States. The proposed policy responses respect the principles of proportionality and subsidiarity. Section 4 lists the general specific objectives of this review.

Section 5 assesses the available policy options caused by (i) fragmented regulation for AIFMs managing loan-originating AIFs, (ii) limited supply of depositary services in smaller markets and (iii) differing interpretation of delegation rules. The options related to (iv) the lack of harmonised availability of liquidity management tools in all Member States, (v) inadequate data reporting for market monitoring and (vi) the unequal treatment of custodians of investment funds' assets are considered in Annex 6 as these policy elements are supported by technical recommendations provided by the ESRB and/or ESMA.

Section 6 assesses the impact and cost implications of the preferred combination of options. Section 7 specifies how the impact of the preferred options will be monitored and evaluated after their adoption.

Certain policy options are also relevant for the UCITS legal framework and this is explained further in those sections covering issues relating to (i) diverging interpretation of delegation regimes under UCITSD, (ii) lack of availability of liquidity management tools by UCITS, (iii) inadequate data reporting for market monitoring and (iv) the unequal treatment of custodians of UCITS' assets. UCITSD legal framework does not contain the level of detail governing delegation arrangements existing in AIFMR. As open-ended funds, UCITS suffer from liquidity pressures in market stress situation like open-ended AIFs, therefore, the measures considered for improving liquidity management of AIFs are relevant also for UCITS. Finally, whilst supervisory reporting data by AIFMs could benefit from the revision, whereas UCITS are not even required to

[21] https://ec.europa.eu/info/files/200610-aifmd-application-scope-working-document_en

make periodic reports on their trades on the basis of a template that would be harmonised at the Union level. Finally, it seems that the recital in the UCITS Directive that was aimed at insuring that CSDs are considered depositaries' delegates is not being followed in all cases for the lack of its normative force, therefore, proposals to this effect contemplated in the AIFMD review should be extended to the UCITS legal framework too.

2. PROBLEM DEFINITION

2.1 Problems

Based on the Evaluation of the AIFMD (Annex 9) and stakeholder feedback (Annex 2) to the public consultation, it is concluded that the AIFMD has generally functioned well and largely achieved its objectives in terms of establishing an effective supervisory regime for AIFMs, ensuring high levels of investor protection and facilitating the creation of the EU AIF market. However, the AIFMD could benefit from targeted improvements to those elements of the framework that have not been sufficiently addressed at the inception of the Directive and to take account of new developments in the market since its entry into force.

As set out in the Problem Tree (Graph 1), three main problems have been identified:

1) Difficulties in monitoring and managing financial stability risks

The AIFMD intended to improve the supervisory oversight and transparency of AIF activities in order to manage the risks they may pose to financial system and to identify potential new risks to the EU and its economy over time. Where the market data submitted to the supervisory authorities has gaps or lacks the requisite detail, their ability to perform this key role may be impaired. This reduces the effectiveness of the AIFMD and may lead to overlooking the build-up and spill over of risks to the broader financial system. Market developments and innovation may have led to the creation of new products that did not exist at the time of the inception of the AIFMD. As concluded in the Evaluation, the regulatory fragmentation in the loan-originating sector poses difficulties in identifying and reacting effectively to the potential market wide effects that may emanate from activities of such funds.

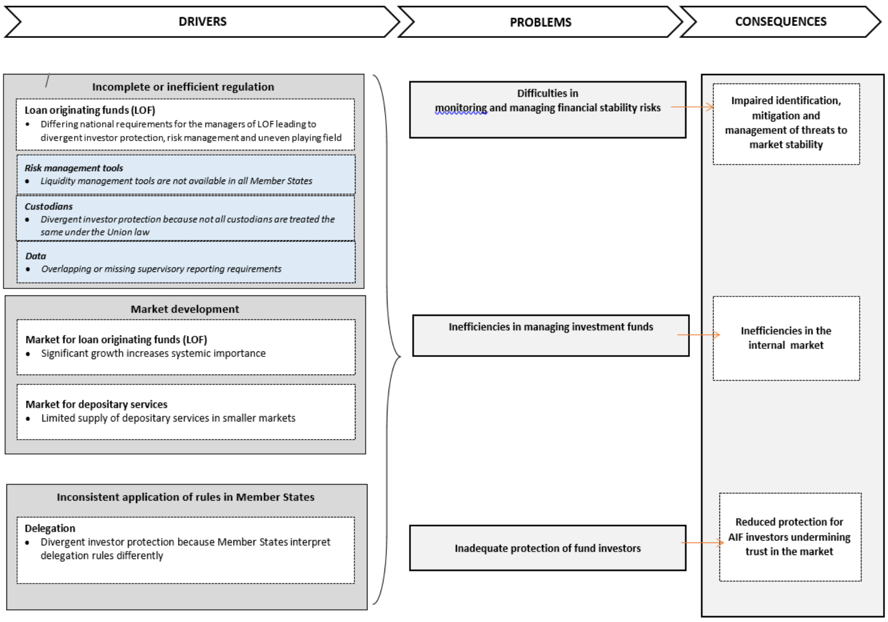
2) Inefficiencies in managing investment funds

Inefficiencies in the regulatory framework can lead to unnecessary additional costs for industry and supervisory authorities. Increased operating costs for the fund managers harm investor returns and high management fees impedes further development of the AIF sector. Persistent under-development of certain sectors and service providers in the AIF market can also lead to level-playing field concerns within the internal market. The Evaluation of the AIFMD shown that there is room for increasing efficiency gains in managing investment funds, in particular levelling the playing field for loan-originating fund managers, streamlining supervisory reporting requirements and diluting market depositary concentration in smaller markets.

3) Inadequate protection of fund investors

A core objective of the AIFMD is a high level of investor protection. The evaluation concluded that divergent interpretations of the legal requirements for fund managers delegating their functions to third parties or different national supervisory practices can create gaps that reduce the overall level of investor protection and trust in the market. Insufficient clarity of the applicable legal requirements leads to less legal certainty, increases divergence in supervisory outcomes ultimately failing to ensure the necessary level of investor protection across the Union.

Graph 1 – Problem Tree



2.2 Problem Drivers

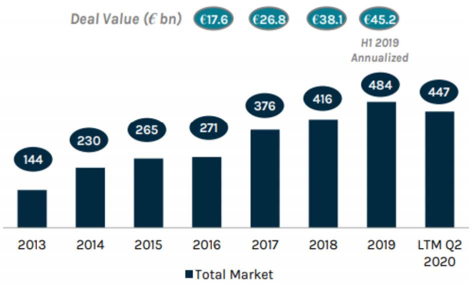
2.2.1 Incomplete or inefficient regulation

a) Differing national requirements for Loan Originating Funds (LOFs)

Since the adoption of the AIFMD in 2011, the market has seen significant growth and innovation in order to generate investor returns. One key trend is the provision of credit by investment funds. This is possible in several ways: loan origination, loan participation and loan restructuring. By carrying out loan origination, an investment fund provides credit while acting as the sole or primary lender. Loan participation typically involves funds that have gained exposure to loans through the secondary market, for example, buying loans from credit institutions. Examples of loan restructuring or 'opportunity' financing include where a fund invests in reaction to the restructuring of existing debt by a corporate issuer.

While the market for direct lending outside the banking sector in Europe is growing, a harmonised framework for loan-originating funds is missing.

Graph 2. European Direct Lending Market Growth. Source: Deloitte Alternative Lending Deal Tracker, Autumn 2020.



This has led to a fragmented regulatory landscape of national regimes, which may affect the ability to address potential micro- and macroprudential/financial stability risks and lead to different levels of investor protection across the EU.

While the AIFMD contains general rules on liquidity management, use of leverage and valuation for managing risks at fund level, these are not specific enough to fully capture the specificities of managing direct lending portfolios and to address the potential micro and macro risks. This increases potential risks to broader financial stability. The differing national legal frameworks imposing varying leverage caps and other limits on risk enhancing techniques as well as insufficient market wide data does not allow sufficient monitoring and containment of potential financial stability risk arising from loan originating funds.

As set out in the Evaluation, AIFs can originate loans without being subject to any specific EU level restrictions because the AIFMD does not contain provisions related to this activity. In the absence of harmonised EU rules for loan-originating AIFs, a number of Member States have chosen to establish their own national frameworks to regulate loan-originating funds leading to divergent approaches, market fragmentation and the concentration of funds in some Member States.

It is important the note that loan origination is a highly specialised activity requiring specific processes, procedures and expertise to ensure that the newly created loans are of sufficient credit quality. Entities in this space must be able to evaluate the credit worthiness of borrowers, assess the potential impact of macro and micro economic changes on the performance of their loan portfolios, actively manage impaired or non-performing loans and comply with applicable prudential and consumer protection regulations.

The accompanying mapping exercise in Annex 7 indicates that loan origination is either partly, or fully allowed in the majority of Member States and that a number of Member States (France, Germany, Ireland, Spain, Malta and Italy) have established bespoke national regimes. For example, Ireland and France require that loan-originating AIFs are managed by authorized AIFMs. Italy, Germany and Malta permit sub-threshold AIFMs to manage loan-originating funds. In fact, 80% of NCAs declared that loan origination was allowed in their jurisdictions for all or part of the AIFs/AIFMs. However, only 33%

of them had a specific framework for this activity.[22] This fragmented regulatory landscape creates uncertainty for fund managers that have to comply with different rules depending on the Member State they are located in leading to increased compliance costs, an un-level playing field and, inhibiting the cross-border activity of these funds and their ability to scale up in size to realise greater economies of scale. For example, divergent leverage limits in different Member States or differing restrictions on loan originating activity lead to different levels of risk mitigation depending on the limits imposed at the national level. This also makes it difficult for supervisory authorities to monitor market developments and manage potential risks as there are no minimum harmonised set of rules against which to assess the fund's activity or market performance at the EU level.

Market data indicates that private credit funds generally do not use significant levels of leverage.[23] However, as the industry becomes larger and increases its share of the loan market in comparison to traditional lenders, it could contribute to self-reinforcing macro-financial mechanisms and credit bubbles that may contribute to the creation of unsustainable debt levels in the non-financial private sector, which may have implications beyond loan-originating funds. This would include risks that could arise from excessive risk taking or the impact of economic cycles particularly where there is a lack of sufficient prudent underwriting standards, effective risk management processes that could expose the loan portfolios to the impact of directional risks such as changes in interest rates. However, macro-prudential authorities lack effective instruments to mitigate such risks, as their scope of intervention is mainly focused on the banking sector (e.g., through the counter-cyclical capital buffer, which is meant to address risks related to excessive credit growth). This asymmetry could further exacerbate regulatory arbitrage and the un-level playing field across the financial system.

According to the AIFMD, NCAs can impose leverage caps on an *ad hoc* basis, however, it is very difficult to time this supervisory action right to contain systemic risks associated with excessive credit growth and leverage across the entire financial system. In this respect, where Member States have established national regimes, they have imposed specific statutory limits on the use of leverage and derivatives by loan-originating AIFs to reduce the potential risks posed by these funds. The ESMA and ESRB recommendations related to loan originating funds are summarised in Annex 5 and contain further details on the potential systemic risks posed by these funds.

Similar to lending banks, loan-originating funds can face a range of risk factors including maturity, liquidity transformation and leverage (see Part I of Annex 5 for a full list of risks). However, unlike banks where the systemic risks have been extensively studied following the global financial crisis, loan-originating funds are not as well understood, also due to the lack of specific disclosure requirements. Under the AIFMR supervisory reporting template, AIFMs have to fill in two data fields: 'leveraged loans' and 'other'. As such, there is no useful breakdown of the originated loans debt classes or reporting of non-performing loans and loans subject to forebearance thus creating difficulties in

[22] ESMA opinion (ESMA/2016/596, April 2016), Key principles for a European framework on loan origination by funds.

[23] ESMA Annual Statistical Report EU Alternative Investment Funds 2020, 10 January 2020 ESMA50-165-1032, p.44. According to AIMA research, "there is typically no more than one unit of debt for one unit of equity in a credit fund. In other words, the leverage rarely exceeds 100% of the funds' net asset value (equivalent of equity)."

monitoring the market for low credit quality loans and potential negative effects thereof on financial stability.

Moreover, depending on the linkages with the banking and insurance sectors, there could be a channel for contagion. The fund industry may seek partnership with banks for a number of reasons, including the ability to adopt best practices for credit analysis, risk management, and the structuring and servicing of loans. Alternatively, banks may also find it beneficial to use funds' balance sheets, including for risk sharing purposes and for financing new lending activities. This interplay can contribute to systemic risks but is not currently addressed in the AIFMD.

The potential systemic risks posed by the growth of loan originating funds has been the subject of research by the ESRB[24], ESMA[25], IOSCO[26], FSB[27] and EBA[28] which have all highlighted concerns related to loan origination by funds:

1) Risk of runs – these funds are invested primarily in non-listed assets that are intrinsically illiquid which poses particular risks in open-ended fund structures which are more exposed to maturity and liquidity risks.
2) Flawed credit risk transfer – as described above, loan origination requires undertaking a thorough credit assessment of the borrower. Granting loans requires specific skills and experience as the process requires not only screening the loans but also their active administration particularly when recovering payments or managing delinquencies. A lack of proper loan risk management may lead to funds undervaluing risk or extending loans without sufficient due diligence.
3) Pro-cyclicality risk – the use of leverage is a risk magnifier. High leverage could imply potential contagion effects for financial institutions through debt financing particularly if the available capital was not sufficient to cover loan losses. If loan originating funds are a major source of credit to the real economy, falling asset prices could lead to their withdrawal from providing credit amplifying the impact of an economic downturn.
4) Inter-connectedness (cross-border and banking sector) – the cross border impact of lending (where may be possible) should be monitored as funds may invest in loans not originated in their country of domicile and sold across the EU with potential systemic implications on other Member States. A key area of risk is the potential interplay between the loan originating and banking sectors. In particular, banks could establish loan originating funds in a manner linked to their own balance sheet management (similar to how securitisation was used before the financial crisis) to reduce their regulatory requirements. Banks could also transfer non-performing loans from their balance sheet to loan originating funds transferring the credit risk to investors.

[24] ESRB response to the European Commission consultation on the review of AIFMD – January 2020.
[25] ESMA opinion on Key Principles for a European framework on loan origination by funds – 2016.
[26] IOSCO Findings of the Survey on Loan Funds Report – February 2017.
[27] FSB Global Shadow Banking Monitoring Report – 2017.
[28] EBA Guidelines on loan origination and monitoring – May 2020.

5) Integrity of the EU financial market – the lack of a harmonised EU framework could undermine broader market integrity if the sector continues to grow (as it is expected to do) in importance within national frameworks and potentially lead to regulatory arbitrage between the jurisdictions. This is the view of ESMA and the FSB which have recommended that minimum regulatory standards are established while allowing Member States to then adopt stricter measures if they wish.

Concerns were also raised about the potential for regulatory competition through a 'race to the bottom' in order to attract entities to locate in that jurisdiction. The FBS states that 'given the importance of contagion risks in global financial markets leaving the door open to regulatory competition of this type may be dangerous'.

In general, fund industry representatives either have no opinion on whether there is a need for further measures tackling activities of AIFMs managing loan-originating funds, or deem the current AIFMD rules sufficient. Public authorities, as evidenced by differing national rules, believe that there is a need for more targeted measures to address micro and macro risks emanating from the activities of such funds.

b) Fragmented rules on and availability of Liquidity Management Tools (LMTs)

During times of market stress, large-scale liquidations or fire sales of assets by asset managers and institutional investors can lead to significant price decreases, which can then impact on investors including other financial institutions (banks and insurers) and translate into broader systemic risk and market instability.

To manage their liquidity profile and risks effectively, AIFMs incorporate liquidity management tools (LMTs) into their portfolio management. These tools include gates, suspension of redemptions, swing pricing, and temporary borrowing that restrict the ability of investors to redeem their holdings and protect both the redeeming investor and those that are remaining invested in the fund. The effective and proper use of these tools can protect the value of investors' money and reduce liquidity pressure on the fund and mitigate against broader systemic risk implications in situations of market-wide stress.

At present, the AIFMD does not provide for a minimum harmonised set of LMTs available to AIFMs that would enable fund managers in every Member State to deal with (future) redemption pressures under stressed market conditions and better handle potential cross-border spill-overs of liquidity tensions.[29] Only the suspension of redemptions by an NCA, a measure of last resort, is explicitly allowed under the AIFMD. In the absence of appropriate LMTs, asset sales by fund managers facing increased redemption requests in response to negative market developments can further exacerbate asset price falls, creating a self-reinforcing negative loop between fund redemptions and asset sales that can endanger broader financial stability.[30] The ESRB has recommended

[29] Additionally, the absence of a minimum set of LMTs may lead to differences between Member States from a market integration perspective.

[30] Analysing investment fund sector developments following the onset of the COVID- 19 crisis, the ECB showed that greater availability and use of ex ante liquidity measures could have mitigated the build-up of systemic risks (https://www.ecb.europa.eu/pub/financial-stability/macroprudential-

the Commission to propose that EU legislation incorporates a common legal framework governing the inclusion of LMTs in the design of investment funds.[31] By law, this recommendation is subject to a comply-or-explain principle.

The lack of homogenised measures makes it difficult for some fund managers to manage liquidity risks effectively, which can spill over to and destabilise the financial system.[32] The varying availability of LMTs in different Member States. National rules are filling in these regulatory gaps that are open at the Union level leading to market fragmentation and insufficient measures for supporting the stability of the financial system. Inefficient and incomplete data reporting further undermines the monitoring development in the markets and management of potential risks to financial stability.

Over the past years, investment funds have taken on more liquidity risks in a search-for-yield due to the prolonged low interest rate environment. In the EU, smaller funds and fixed-income funds have increased their average portfolio maturities making them more vulnerable to liquidity shocks (IMF GFSR October 2019). In its FSR of November 2020, the ECB concluded that investment funds are again increasing their liquidity risk-taking after the market turmoil of Spring 2020.[33] Two thirds of open-ended AIFs offer daily redemptions, but at an aggregate level, the sector's liquidity profile shows that they may not hold sufficient liquid assets to sell within that period to meet redemption requests.[34] Liquidity stress events can expose investment funds to high and rapid redemption requests, as it happened in the 2008 crisis, in the 2011 and in the March 2020 turmoil.

ESMA observes in a letter to EVP Dombrovskis in August 2020 on the AIFMD Review[35] "*the experience of market dislocation during the on-going COVID-19 crisis also demonstrates the need for all LMTs to be available in all jurisdictions in a consistent manner*." As this was not the case, AIFMs in some Member States were not able to use (certain) LMTs. The availability and implementation of LMTs for investment funds varies significantly across the Member States, despite similarities in fund characteristics.[36] (*see* Table in the Annex 8 with the overview of LMTs across the EU).

The November 2020 ESMA report reveals important weaknesses, which should be addressed: (i) some funds presented potential liquidity mismatches and weak liquidity

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bulletin/html/ecb.mpbu202104_3~a7ddbf0d16.en.html). *Ex ante* LMTs, such as swing pricing, can contribute to mitigating liquidity risks by reducing the first-mover advantages.

[31] ESRB Recommendation 2017/6 of 7 December 2017 on liquidity and leverage risks in investment funds.

[32] Analysing investment fund sector developments following the onset of the COVID- 19 crisis, the ECB showed that greater availability and use of ex ante liquidity measures could have mitigated the build-up of systemic risks (https://www.ecb.europa.eu/pub/financial-stability/macroprudential-bulletin/html/ecb.mpbu202104_3~a7ddbf0d16.en.html). *Ex ante* LMTs, such as swing pricing, can contribute to mitigating liquidity risks by reducing the first-mover advantages.

[33] For instance, the share of liquid debt securities held by euro area investment funds has declined from 36% in 2013 to less than 30% in June 2020.

[34] ESMA Annual Statistical Report on EU Alternative Investment Funds 2021, pp. 13-15.

[35] https://www.esma.europa.eu/sites/default/files/library/esma34-32-551_esma_letter_on_aifmd_review.pdf

[36] See ESMA report on preparedness of open-ended investment funds to potential future adverse shocks, https://www.esma.europa.eu/sites/default/files/library/esma34-39-1119-report_on_the_esrb_recommendation_on_liquidity_risks_in_funds.pdf (pp. 38, 47, 53, 55, 60). See also p. 32 of ESMA's September 2020 report on Trends, Risks and Vulnerabilities: https://www.esma.europa.eu/sites/default/files/library/esma_50-165-1287_report_on_trends_risks_and_vulnerabilities_no.2_2020.pdf.

risk management or valuation processes due to their liquidity set up,[37] and (ii) despite the severity of the 2020 liquidity crisis, only a few funds have adjusted their liquidity set-up in light of the issues encountered.[38] The report cautions against taking too much comfort from how funds managed to cope with market stress in spring 2020, as that took place 'amid significant government and central bank interventions which provided support to the markets in which these funds invest and relatively short in time.[39]

In most Member States, fund managers are solely responsible for the activation of almost all liquidity management tools, and do usually not need regulatory authorisation to do so. Typically, LMTs and the circumstances under which they can be used must be listed in the constitutional and contractual documents of the investment fund, which are subject to authorisation in EU Member States. The availability of the tools is, in some cases, restricted to certain types of investment funds and/or to exceptional circumstances.

However, fund managers are often not keen to activate LMTs due to competitive or reputational reasons. They may also not internalise that forced asset sales in response to large-scale redemptions may have negative implications for the stability of the financial system.[40] The AIFMD provides a limited harmonised solution permitting NCAs to step in and suspend redemptions in the public interest. Nevertheless, NCAs usually do not have the power to activate LMTs other than suspension of redemptions. For example, redemption gates are a more nuanced tool, as they can still allow investors to redeem a part of their AIF shares and thus limit the extent to which liquidity shocks are spread across the financial system. However, only in a number of jurisdictions NCAs are granted the power to activate redemption gates.[41] Currently, the AIFMD framework does also not explicitly include provision on ensuring consistency in application and coordination across borders if NCAs would use their powers, as also signalled by the ESRB.

c) Differential regulatory treatment of custodians of AIF and UCITS assets

The AIFMD was adopted prior to the CSDR and therefore does not fully take account of the different functions that CSDs can perform. It does not clearly distinguish the situations when CSDs are acting outside their primary function as market infrastructure (as Issuer CSD) and are competing with other custodians to provide custody for AIFs (as Investor CSD).

An incomplete regulation of custodians of investment funds' assets at the Union level is undermining investor protection, which depositaries are meant to guard. It is worth to mention that the ongoing CSDR review has no impact on this analysis, as it does not touch the custody activity of Investor CSDs.

The AIFM needs to appoint a depositary and only certain entities can act as depositaries (credit institutions, under certain conditions investment firms and other institutions

[37] E.g. a combination of high redemption frequency, no/short notice periods and no LMTs in the case of funds investing in asset classes either illiquid by nature or whose liquidity may recede during a period of market stress.
[38] e.g., introduction of LMTs, adaptation of the redemption frequency and notice period.
[39] Ibid., p. 6. Cf. pp. 22, 27, 53.
[40] Supra 37, ESRB recommendations.
[41] Ibid.

subject to prudential regulation). The depositary has extensive duties and tasks, including monitoring of cash flows, carrying out instructions from the AIFM if they do not conflict with fund rules or national law, and safekeeping of assets, which means either custody of financial instruments or verification of ownership for other assets. Custody is the only task a depositary can delegate. This implies in return that all the necessary checks, e.g. including checking that no financial instrument has been lost, still need to be undertaken by the depositary itself and that the information flow in the custody chain, and more precisely between the depositary and its delegate, needs to be complete, timely and smooth.

Under the AIFMD, however, a Central Securities Depositary (CSD) is not considered to be part of the custody chain and thus it is not considered a delegate of the depositary.[42] This legal situation does not guarantee a stable information flow between the custodian of an AIF's asset and the depositary. Consequently, depositaries' ability to fulfil their oversight duties effectively is impaired absent a stable flow of information on the portfolio movements.

Moreover, CSDs, in contrast to custodians acting as delegates of the depositaries, are not subject to the asset segregation rules as laid down in the AIFMR. Instead, they follow the CSDR rules in this respect that in many jurisdictions are less detailed.

It was attempted to solve a similar issue in the UCITS legal framework by inserting a recital in the UCITS V. The recital states that when CSD act as custodians they should be considered as delegates of the depositaries. Due to the lack of normative force, however, the recital seems to be often ignored in practice and hence the discussed issues persist where CSDs hold in custody UCITS assets.

ESMA carried out extensive work on this matter and in its Opinion strongly recommends a legislative intervention to address the issue.

Anecdotal evidence was provided by a number of depositaries on a confidential basis regarding delegation of custody to investor CSDs. This evidence shows that in several Member States investor CSDs hold a share of more than 8% of the financial instruments entrusted for custody to the depositary. This share can exceptionally exceed 30% of the financial instruments, which can be held in custody. In these cases, where depositaries are not ensured a stable information flow and therefore cannot discharged their duties properly, the investor protection is weaker.

d) Overlapping or missing supervisory reporting data

Timely, high quality reporting of relevant data is vital for supervisors to monitor developments in the markets and address potential risks to financial stability stemming from AIFM and AIF activities. The AIFMD lays down principles for supervisory reporting, which are further detailed in a Regulation supplementing the AIFMD - AIFMR. However, the AIFMD Report and AIFMD Evaluation concludes that the AIFMR template is not sufficiently granular for effective market monitoring.

Moreover, the fitness check of supervisory reporting requirements existing across different EU financial laws revealed that there was a significant overlap between the AIFMR supervisory reporting obligations and reporting to the ECB for statistical

[42] The last indent of Article 21(11).

purposes. A more detailed study is currently on-going to investigate a potential approach for an integrated reporting of respective supervisory and statistical data. This could potentially lead to reduced administrative burdens in the area of reporting by reducing duplicative, but different reporting obligations (for more details see evaluation in Annex 9 on the fitness check). The current inefficient and incomplete supervisory reporting obligations impede better monitoring of developments observed in the markets and addressing potential financial stability risks.

The KPMG general survey and semi-structured interviews revealed that regardless of the reporting template included in Annex IV of the AIFMR, the reporting requirements differ among NCAs, with different interpretations or additional requirements. AIFMs that have reporting obligations to NCAs located in Member States in addition to their home office domicile, or if the AIFM invests in a target company located in a different specific observed the differences in filing procedures and translation costs were said to add to the administrative and cost burden.[43] Most of the respondents, therefore, would support a rationalised template and a consistent application of the AIFMD reporting requirements. Considering the high costs of implementation of the reporting requirements, it is advised strongly to have a cross-sectoral view at regulatory reporting and to look for possible cost reductions and efficiencies for managers.[44]

AIFMR supplementing the AIFMD requires only the reporting of aggregated data, such as the 5 most important instruments in which the AIF trades, 10 principle exposures, 5 most important portfolio concentrations etc., at times may provide an incomplete picture of the funds activities for the supervisory authorities depending on the whole investment portfolio. In addition, ESMA, ESRB and industry stakeholders consider that addressing other current data gaps would improve macro-prudential monitoring.

The examples of the missing information include collecting data on loan origination, details on initial margin and variation margin, and Value at Risk. The ESRB suggests that a mandatory Legal Entity Identifier (LEI) for AIFs could enhance financial stability monitoring by enabling matching various data sets reported under different Union laws (e.g. EMIR). A direct link to other data sets, especially transaction reports, is currently not possible in many cases as only the AIFMs hold LEI but not the individual funds they manage (i.e. often the same LEI used for multiple funds). Also, over 60% of AIFs are self-classified as ‘other’. The ESRB recommends improving the reported self-classification of funds and to report the use of certain instruments. IOSCO, for its part, promotes a global approach to leverage reporting by focusing on leverage by asset class.

Insufficient data makes monitoring of market developments and identifying risk built-ups in the system difficult, which increases risks to financial stability.

[43] Report on the Operation of the Alternative Investment Fund Managers Directive (AIFMD) - Directive 2011/61/EU, retrieved from:
[https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/190110-aifmd-operation-report_en.pdf] (KPMG Report), pp.75 and 115.
[44] Ibid.

2.2.2 Market Developments

a) Growth in AIFMs managing Loan Originating Funds (LOFs):

The tighter regulation and increased capital requirements imposed on traditional lending banks through Basel III have reduced the capacity for banks to issue loans to higher risk borrowers such as SMEs or to already highly indebted entities (leveraged loans).[45]

Graph 3. EU Bank's Share of Leveraged Loan Market. Source: Standard and Poor's LCD Q3 2020 Leveraged Lending Review.

In comparison to traditional lenders such as banks, funds are not subject to the same type of capital requirements, as they do not hold customer deposits in order to serve as a base to extend credit, albeit their AIFMs are subject to rules on liquidity risk management.[46] This feature enables these funds to continue lending even during times of extreme market stress while avoiding liquidity mismatches.

According to the OECD[47], loan-originating funds constitute an important and widely-used source of funding for SMEs, which in Europe face more limited borrowing options and are typically reliant on banks. At the same time, institutional investors have looked to diversify their assets in the search for yield in the current low-interest rate environment. These factors have created a gap in the market that loan-originating funds have sought to fill (Graph 3 below). Market research indicates that the global private debt funds reached $887 billion with nearly $188 billion in capital raised during 2020.[48] According to a report by Deloitte, private debt is now the third largest fund class behind only private equity and real estate funds.[49]

[45] FSB paper Vulnerabilities associated with leveraged loans and collateralised loan obligations defines leveraged loans as follows:
"There is no commonly agreed definition for leveraged loans. However, criteria used by regulators and data providers to classify a loan as "leveraged" typically include: (i) high indebtedness of the borrowing corporate (e.g. gross debt to earnings before interest, tax, depreciation and amortisation (EBITDA) ratio 4x or higher); (ii) below investment grade credit rating for the loan (or borrower) (i.e. below BBB); (iii) loan purpose is to finance an acquisition (e.g. management buy-out (MBO) or leveraged buy-out (LBO)); (iv) presence of a private equity sponsor in the transaction (e.g. financing of borrowers owned by financial sponsors); or (v) high loan spread at issuance (e.g. +125 basis points)."
[46] A close-ended AIF does not repurchases or redeems its shares or units with its investors, at the request of any of its shareholders or unitholders, prior to the commencement of its liquidation phase or wind-down. Article 1 of Commission Delegated Regulation (EU) No 694/2014 of 17 December 2013 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to regulatory technical standards determining types of alternative investment fund managers, OJ L 183, 24.6.2014, p. 18–2.
[47] New Approaches to SME and Entrepreneurship Financing: Broadening the Range of Instruments, OECD 2015.
[48] Preqin: *Private Debt Fared Well During a Strained 2020*; available at: https://www.preqin.com/Portals/0/Documents/PD-Global-Feb21.pdf?ver=2021-02-04-132616-123
[49] Deloitte Alternative Lender Deal Tracker Autumn 2020; available at: Deloitte ALDT - autumn 2020 Belgium.pdf.

While the pandemic led to reduced growth in 2020, 25 new direct lending funds still raised $23.4 billion in funding with the largest fund, the GSO European Senior Debt Fund II raising $6.1 billion.[50] Given the low returns on government debt generally, it is expected that investors will continue to increase their allocation to this fund class.

With particular regard to leveraged loans, ESMA statistical report on EU AIFs concludes that over the past few years EU AIFs' exposures to leveraged loans and collateralised loan obligations (CLOs) have increased by 15% reaching € 108bn by the end of 2018 compared with €95bn in 2017.[51] The growing attractiveness of this asset class is evidenced by the fact that "*the increase in exposures comes from AIFs with no previous exposures to the leveraged loan market*."[52]

In a proper functioning and effectively supervised Capital Markets Union (CMU), loan-originating funds have the potential to provide an alternative source of financing to Europe's corporates and SMEs allowing them to access a wider range of competitively priced funding options.[53] This allows these funds to directly support job creation, economic growth, innovation and contribute to the recovery from the Covid-19 pandemic. Loan-originating funds can also serve as a backstop or shock absorber when liquidity is constrained by continuing to provide loan financing when more traditional lenders such as banks have pulled back from the market. At the same time, the lack of a proper incentive structure, in terms of governance and risk management, aiming at avoiding excessive risk-taking by loan originating funds, may lead to potential financial stability risks, especially if we consider the interconnectedness of the investment funds' sector with the banking and insurance sector in the EU.

As set out in the Evaluation, the divergent approaches across Member States can prevent funds from accessing certain national markets, limit cross border competition and the ability of the funds to scale up their portfolios. It can also present a challenge with regard to the level playing field in the internal market as funds in some jurisdictions may be subject to more stringent rules or total prohibitions on engaging in loan origination, which produces inefficiencies in the internal market.

The syndicated loan market[54] has a level of inherent discipline around credit assessment and monitoring because loans must be structured and priced accurately in order to satisfy potential lenders. In the absence of specific EU regulatory requirements, it is not certain that similar levels of discipline exist in direct debt financing or loan origination activity by AIFs and a number of risks can arise as a result.

This is particularly important in the context of an observed deterioration of underwriting standards and lower credit quality of leveraged loans.[55] Some national frameworks have

[50] Ibid., Deloitte.
[51] ESMA Annual Statistical Report EU Alternative Investment Funds 2020, 10 January 2020 ESMA50-165-1032, p.42.
[52] Ibid.
[53] Ibid.
[54] A syndicated loan, or syndicated bank facility, is financing offered by a group of lenders - referred to as a syndicate - who work together to provide funds for a single borrower.
[55] ESMA Annual Statistical Report EU Alternative Investment Funds (2020), 10 January 2020 ESMA50-165-1032, p.44. Cf. Financial Stability Board (2019), Vulnerabilities associated with leveraged loans and collateralised loan obligations, section 2.

imposed requirements on funds governing their credit assessment and granting processes or requiring stress testing of the portfolios to determine the resilience of the loan portfolio to general economic shocks such as interest rate changes. However, there are no common set of rules applicable to all AIFMs managing loan originating funds to establish a minimum level of good practice in the EU and to support the growth in sources of alternative financing in the Union.

It is important to note that loan-originating funds generally do not have access to public backstops or central bank liquidity. If a fund encounters difficulties due to poor lending practices or a failure to properly manage its risk exposures and bad debts, this may negatively affect investors in the fund and its borrowers, particularly in the event of a fund's failure. Generally, this is a positive feature as a failure would be limited to the fund and its investors. However, in certain circumstances, it could translate into broader systemic risk depending on the fund's overall size, its interconnectedness with the broader financial system and the degree of concentration of its loan book in certain sectors of the real economy.

For funds engaged in loan origination, it is important that they have staff with the relevant skills and expertise in loan origination to ensure a robust and effective credit assessment and granting process to prevent the accumulation of or concentration in excessively risky loans or bad debts that may impair the fund's performance. In terms of best practices among loan originators to effectively manage their risks, research suggests a highly involved selection process requiring specialist skills to identify projects, undertake due diligence, negotiate loan terms, extending credit and monitoring the loans once they are on the books. Different national requirements in this respect undermine a development of expertise and an efficient loan-originating fund market in Europe.

b) Limited supply of depositary services in smaller markets

One of the main pillars of the AIFMD framework protecting investors is a depositary regime. AIFMs are required to appoint a single depositary for each AIF they manage to safe-keep AIF assets, monitor cash flows and ensure the AIF's compliance with the relevant regulations and fund rules.[56] AIFMD requires the depositaries to have their registered office or a branch in the same country as an EU AIF under their care.[57] As established by the Evaluation, the regime is deemed to be robust and is functioning well. However, there is an outstanding problem of a limited supply of depositary services in smaller markets.

Originally, during a transitional period that lasted until July 2017, the competent authorities of the home Member State of an AIF could allow the appointment of a depositary established in another Member State.[58] Several competent authorities made use of this possibility in order to avoid a market concentration, which could pose risks to the financial stability in the concerned Member States. However, after that date, this avenue for AIFMs or AIFs reliant on depositary service providers established in other Member States was closed.

[56] Article 21 AIFMD.
[57] Article 21(5) AIFMD.
[58] Article 61(5) AIFMD.

The ending of the transitional period caused difficulties for certain AIFs/AIFMs in smaller markets where there is still a sufficient lack of supply of depositary services. A few Member States have an extremely concentrated depositary market. For example, in one Member State two depositaries hold over 40% of the financial instruments and four depositaries hold 70% of the financial instruments. In another Member State only three depositaries offer their services.

Table 1: AIF Net Assets compared to number of depositaries for a selection of Member States

Member State	AIF Net Assets at end 2020	Number of depositaries
Germany	2.1 € trillions	35
France	1.2 € trillions	18
Netherlands	1.0 € trillions	27
Luxembourg	0.8 € trillions	49
Ireland	0.8 € trillions	22
Malta	11,115 millions €	7
Cyprus	4,463 millions €	3

Sources: AIF Net Assets: EFAMA quarterly statistics March 2021; Number of depositaries: national competent authorities and asset management associations

Respondents to the public consultation observe, that such market structures have cost implications for fund managers and investors and can cause limitations to the provision of more cost-efficient packaged services that could for example, also include fund administration (NAV calculation, unit/shares issuing service). Therefore, AIFMs have to internalise these services, which can be highly inefficient and expensive for some AIFMs (that have to create and maintain dedicated teams regardless of their size) and consequently for the investors.Indicatively, AIFMs operating in the Baltic markets usually bear 20 -70 bp on the basis of the assets under management (and depending on the types of assets, where they are issued and if they are held outside the EU). EU only assets attract 5-10 bp. This is much higher than what the AIFMs/AIFs bear in competitive markets (1-2 basis points for larger AIFMs and up to 10 basis points for smaller AIFMs and AIFMs specialising in Private Equity and Venture Capital) [59]. This anecdotal evidence dates from 2009; contractual information is confidential and therefore

[59] Charles River Associates, Impact of the proposed AIFM Directive across Europe (prepared for the Financial Services Authority, UK), October 2009, p.102.

in general not accessible. Given that the number of depositaries has remained stable or decreased[60], there are no grounds to believe that the costs for depositary services lowered. Inefficiencies in certain Member States persist and cause decreased competition in the internal market for AIFs. Moreover, a failure of a depositary holding a large share of the AuMs would have significant repercussions on the AIF sector and investors.

2.2.3 Inconsistent application of rules in Member States

Delegation

The AIFMD and UCITS rules permitting fund managers to delegate their core or non-core functions to third parties are designed to ensure that it is possible to control the delegate effectively and to ensure a proper execution of the delegation mandate thus serving investor interests. However, differing interpretation and application of the AIFMD and UCITSD rules on delegation by NCAs is leading to potential investor protection concerns depending on where the fund manager is domiciled. The delegating fund manager may not be subject to the same level of substance requirements in every Member State.

A lack of clear legal requirements in the Union law leads instead to national regulatory guidelines, which impose divergent substance requirements for AIF and UCITS managers. For example, there are differing national guidance on the number and classification of employees, conducting officers or senior/board members an AIF or UCITS manager in the Union should have so that it can be deemed sufficiently staffed to ensure the effective monitoring of activities of the entity receiving the delegation of portfolio or risk management.[61] Depending on the Member States of their establishment, AIF and UCITS managers are subject to different regulatory standards when they use delegation, which results in different levels of investor protection.

Pursuant to the AIFMD and UCITSD, managers of AIFs and UCITS are allowed to delegate core functions (portfolio or risk management) and non-core functions (fund administration, marketing or record keeping) to third parties while retaining the liability and obligation to control the delegate. The AIFM must properly supervise the delegate and be able to withdraw delegation immediately, while being liable at all times towards the managed AIF and investors, who remain covered by the investor protection measures provided for in the Union laws.[62]

Before delegation arrangements become effective, AIFMs must notify NCAs so they can assess whether the delegation structure is objectively necessary. The acceptable

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[60] Cases of insolvency or closing of business which reinforce the concentration in the concerned markets were reported.

[61] Example of substance requirements in Luxembourg (Circular CSSF 18/698): an AIFM should have (i) at least three board members/members in its governing bodies with some conditions on the other mandates they can have (e.g. less than 20 mandates in regulated entities and operational companies and they cannot dedicate more than 1920 hours per year to their professional commitments), (ii) at least two conducting officers in Luxembourg who should be members of the senior management committee.
Example of substance requirements in Ireland: an AIFM should have (i) a minimum of two directors, (ii) other constraints may be imposed by the CBI based on its risk-based assessment (e.g. conditions on the board members residence or on the designated persons in charge of key functions).
[62] Article 20(1)(f) of the AIFMD, Article 75(f) of the AIFMR.

justifications most commonly include optimisation of business functions and costs, seeking expertise of the delegate in specific markets or accessing global trading capabilities.[63] Often delegation serves a useful purpose by connecting European investors with investment opportunities and expertise in third country markets to meet their investment needs and properly diversify their investment portfolios.

However, AIFMs can no longer be considered as a fund manager under the Directive, if through an improper use of delegation, they become letterbox entities. An entity is no longer considered to be an AIFM where it does not ensure a permanent supervision of the delegate, or where it does not retain the prescribed standard of decision making.[64] The AIFMR states that performance of investment management functions by a delegate should not exceed by a substantial margin such functions performed by the AIFM itself. When the AIFMD and AIFMR delegation rules are not respected, the AIFM may no longer be considered as a manager of the AIF concerned and the AIFM licence can be taken away. However, the 'substantial margin' criterion is too vague leading to its divergent application and enforcement by different NCAs.

The relevant rules in UCITSD are even less detailed or prescriptive than the AIFMD. The UCITS regulatory framework mirrors some of the principle rules laid down in the AIFMD by outlawing the formation of letter-box entities and requires UCITS managers to monitor effectively the activities of the delegates.[65] The Commission is only invited in a recital to examine the possibilities for further harmonising delegation arrangements applicable to UCITS at Union level but no such specific requirements have been adopted yet.[66] In effect, the same issue persists in this market.

ESMA has issued guidelines advising NCAs to apply the AIFMR approach to UCITS funds but there are persistent disagreements among the NCAs, some of which argue that the UCITS regime is less prescriptive and therefore more permissive.[67] This results in different supervisory outcomes across Member States producing a varying protection for European investors.

An absolute majority of industry representatives believe that the current AIFMD and UCITS rules on delegation are sufficient and warn against tampering with the valuable tool, which benefits European investors and European fund industry. They agree, however, that proliferation of letter-box entities should be prevented and would welcome clarifications around substance requirements. At least a third of the European NCAs, on the other hand, have advocated for greater clarification of the Union rules to prevent regulatory arbitrage and to ensure the necessary levels of investor protection.

2.3 Consequences

2.3.1 Impaired identification, monitoring and management of potential threats to financial stability

[63] This list is not exhaustive. Article 20(1)(a) of the AIFMD and Article 76 of the AIFMR.
[64] Article 20(3) of the AIFMD, which is further detailed in Article 82 of AIFMR.
[65] Article 20(3) of the AIFMD.
[66] Recital 17 of the UCITS Directive.
[67] https://www.esma.europa.eu/sites/default/files/library/esma34-45-344_opinion_to_support_supervisory_convergence_in_the_area_of_investment_management_in_the_context_of_the_united_kingdom_withdrawing_from_the_european_union.pdf

The AIFMD does not contain specific rules that would address the potential micro and macro risks, which increases potential risks to the broader financial stability. The differing national legal frameworks imposing varying leverage caps and other limits on risk enhancing techniques as well as insufficient market wide data does not allow for a sufficient market-wide monitoring. This regulatory situation impairs the identification, monitoring and management of potential threats to financial stability arising from loan originating funds.

The lack of a harmonised set of LMTs across the Union means that managers in different Member States may be limited in their ability to respond to periods of market stress and liquidity shortages thus possibly engaging in forced asset sales that can further amplify systemic shocks across the financial system.

Timely, high quality reporting of relevant data is vital for supervisors to monitor developments in the markets and address potential risks to financial stability stemming from AIFM and AIF activities. The reporting of data is of particular importance for supervisors and policy maker in the times of stressed markets. Where there are gaps in the supervisory reporting, these will limit the effectiveness of the supervisory oversight and the ability to identify and intervene to address emerging risks.

Given that protecting financial stability is one of the core objectives of the AIFMD, it is important to ensure that supervisors have access to sufficiently detailed fund level data and that the framework remains up to date to account for developments in the market such as the use of liquidity management tools and new investment products with specific risk profiles.

2.3.2 Inefficiencies in the internal market

Overlapping reporting requirements lead to inefficiencies for fund managers, investors and supervisors. This duplicative administrative burden increases costs for managers, reducing fund returns for investors and impairing the competitiveness of EU AIFMs. Lack of competition among service providers, particularly in smaller markets can lead to increased costs for managers and less efficient fund structures due to a lack of local service providers and insufficient competition. The internal market efficiency is undermined where fund managers are subject to differing national requirements, in particular where those restrict economic rights by reserving them for domestic market participants.

2.3.3 Reduced protection for AIF investors undermining trust in the market

The different national rules applied to AIFMs managing LOFs can lead to divergent levels of investor protection due to different fund level requirements for disclosure of supervisory data, different risk management requirements and the lack of harmonised rules for the granting of credit.

Different interpretations and implementation of the rules on delegation can pose risks to investors, particularly where there is a lack of effective oversight of the delegate.

Different regulatory treatments of the custodians of AIFs assets can impair supervisory monitoring and pose a risk to investor protection where depositaries are not provided with all the data necessary to perform their oversight role of the funds activity.

2.4 How will the problem evolve if not addressed?

This section contemplates how the defined problems would evolve should the European Commission propose to do nothing to address them. The considerations below are "baseline scenarios" – 'Option 0' – followed by the possible policy options for each problem discussed in Section 7.

2.4.1 Difficulties in monitoring and managing financial stability risks

a) Potential risks emanating from AIFs originating loans

The retreat of the banking sector and growth of non-bank lending is one of the biggest and most significant trends in the European economy and financial system during the last decade. In the EU, the non-bank financial sector has already reached the same size as the banking sector in terms of financial assets – a trend that is expected to continue.[68] In Eurozone non-bank credit, where the ultimate lender is a non-bank financial institution rather than a bank irrespective of the mode of financing, makes up around one-third of total credit from financial institutions.[69] ESMA and NCAs have observed the continued expansion of private equity funds, which are active in extending loans. It is estimated that European focused AuM makes up 30% of the total or approximately €266 billion up from 25%.[70] It is also predicted that the global private debt market will nearly double in size to $1.4 trillion by 2025.[71]

Further progress towards the CMU will strengthen the role of market-based finance in Europe and lead to a more diversified financial system. Without common EU standards the potential risks generated by loan-originating funds are likely to increase and concentrate in some parts of the internal market making it difficult to control and address them at the EU level.

In addition, this market segment will remain fragmented by a patchwork of national rules (see Annex 7 mapping national regimes across the Union) impeding its coherent development without being subject to the appropriate safeguards and restrictions, for example, regarding the use of leverage or limiting inter-connectedness with the other components of the financial system. This may limit the ability of supervisory authorities to effectively monitor and manage potential risks from this sector, particularly as it continues to grow in size.

b) Constrained management of liquidity risk under stressed market conditions

In the absence of appropriate liquidity management tools, asset sales by fund managers facing increased redemption requests in response to negative market developments can further exacerbate asset price falls creating a negative loop between fund redemptions and asset sales and endangering systemic financial stability. If the necessary LMT tools

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[68] See e.g. ESRB NBFI Monitor 2020, p.60 https://www.esrb.europa.eu/pub/pdf/reports/nbfi_monitor/esrb.202010_eunon-bankfinancialintermediationriskmonitor2020~89c25e1973.en.pdf?588be9e8391cfb17584d2a283dfe0abe

[69] Financial Stability Review, November 2020 (europa.eu).

[70] Industry estimate [not published information].

[71] Supra 60; Preqin.

remain unavailable in certain parts of the Union to fund managers or to NCAs for their activation this will limit the availability of an effective and coordinated response mechanism to the market stress and liquidity shortages. Failing to tackle the perceived reputational cost and competitive pressure whereby fund managers refrain using certain LMTs tools even if they are more effective, would continue having detrimental effects on financial stability and on investor interests. Failing to activate the relevant liquidity tools where it is warranted the fund managers are likely to fail in protecting the value of investors' money.

c) Inadequate supervisory data reporting

Failing to harness potential synergies between the ECB statistical reporting and the AIFMR supervisory reporting will lead to AIFMs bearing a double burden of mandatory reporting to different authorities regarding the same activities. Securities markets supervisory efforts to monitor markets closely will continue to be impeded by insufficient granularity of the reported data under the AIFMR because many of the submitted values are aggregated (e.g. 5 main exposure, 5 main counterparties, etc.). The existing data gaps will continue impeding supervisors' understanding of market developments and accumulating risks. This reduces their ability to respond to emerging risks in a timely and effective manner. This is particularly relevant during times of market stress or crisis with unforeseen market shocks where the immediate need to react is impaired by an incomplete understanding of the market situation.

2.4.2 Inefficiencies in managing investment funds

a) Market inefficiencies linked to uneven playing field for loan-originating AIFs

The loan originating funds sector is expected to become an ever more important source of financing to the real economy. This is supported by market data and research as explained in section 3.2. In the absence of harmonised EU rules, the sector will continue to rely on fragmented national frameworks to operate in Europe, which will impair funds ability to scale up in size, realise cost savings through economies of scale or access new markets where they are currently prevented from carrying out loan origination. Fund managers would continue to incur higher compliance costs due to differing requirements between Member States leading to uncertainty and limiting their ability to operate on a cross border basis. This would also impair the development of the CMU and the development of alternative sources of finance for the real economy. Harmonising the requirements for loan originating funds will improve their ability to operate across the Union, lower compliance costs and level the playing field between the different jurisdictions.

b) Market inefficiencies linked to limited supply of depositary services in smaller markets

The current status quo whereby EU AIFs must appoint a depositary in the same Member State or that the depositary has established a branch in the Member state where the fund is established would perpetuate the situation in smaller markets of a limited supply of depositary services. This means that the number of depositaries active in these markets would remain low. For depositaries to run a profitable operation, they need scale, which is not possible in smaller markets. This implies a potential lack of sufficiently robust depositaries; e.g. some depositaries have a low investment grade. A lack of sufficiently robust depositaries, as well as the predominance of depositaries offering limited services (e.g. no fund administration), poses in particular a problem for AIFs with a high(er) number of AuM and might also concern AIFs with certain underlyings (e.g. private equity or yet exotic derivatives). Market concentration in smaller markets would also perpetuate insufficient competition and therefore inefficient functioning of the AIF market. In these highly concentrated depositary markets funds often do not have access to packaged services. As a result, the investment funds market in such Member States is likely to remain underdeveloped, the investment choice for the investors would continue to be restricted.

Having such barriers is at odds with the rationale and spirit of the internal market and prevents managers from accessing the most cost efficient service propositions.

2.4.3 Inadequate protection of investors

a) Investor protection issues where the fund manager delegates its functions to third parties

Failing to take measures at the Union level, NCAs would continue enforcing AIFMD and UCITSD rules of delegation with divergent interpretations and implementation at national level. This leads to divergent supervisory outcomes to the detriment of ensuring a uniform level of investor protection in the Union. Entities willing to exploit accommodative national guidance may seek to establish in the Member States where the standards are perceived as being lower leading to possible regulatory arbitrage. At the same time, the current rules on delegation are important to European fund managers as a cost saving measure and means to access foreign market expertise and knowledge allowing investors safely diversify their investment portfolios. The purpose of clarifying and specifying existing rules on delegation is to seek better alignment of supervisory practices across the EU in order to ensure the protection of investors.

b) Investor protection issues with CSDs as custodians of funds' assets

Not putting CSDs on an equal footing with other custodians when they provide competing services will perpetuate an unjustified advantage for the CSDs and impede depositaries in carrying out their duties in accordance with the AIFMD and UCITSD.

c) Diverging protection of investors in loan originating funds

In addition to new and growing risks to the financial stability and limiting the development of the internal market for loan originating AIFs, differing national rules can lead to divergent levels of investor protection as AIFMs of such funds will be managing micro risks and will be providing investor disclosure information according to the nationally designed regulatory standards. NCAs may not have access to the full set of information they need to ensure effective oversight of these funds and the monitoring of potential risks. As these funds grow in size these issues will amplify further.

3. WHY SHOULD THE EU ACT?

3.1 Legal basis

The Treaty on the Functioning of the European Union (TFEU) confers upon the European institutions the competence to lay down appropriate provisions that have as their object the establishment and functioning of the internal market (Article 114 TFEU).

For the policy options chosen and the specific design of the rules, the appropriate legal base could be Article 53(1) TFEU on the taking-up and pursuing of activities by self-employed persons, which is used to regulate financial intermediaries, their investment services and activities.

Divergent national approaches to the issues discussed in the preceding sections can make the cross-border provision of services difficult and impede the development of internal market for such AIFs. Insufficient supply of depositary services and different national regulatory standards for loan-originating AIFs undermine level playing field for AIFs. Moreover, the patchwork of national rules on loan-originating AIFs make it more difficult for supervisors to monitor risk to the financial stability and to preserve market integrity.

The proposed improvements to the AIFMD seek to promote sound processes for loan origination by AIFs and to further market integration in this segment. Facilitating access to cross-border provision of depositary services aim to facilitate a further integration of EU AIF market ensuring high level of investor protection. It is sought to achieve a coherent approach to delegation activities by European investment funds. Unilateral actions of Member States cannot fill in the AIFMD gaps to achieve these objectives individually. Therefore, the Union may adopt measures in accordance with the principle of subsidiarity as set out in Article 5 of the Treaty on European Union.

3.2 Subsidiarity: Necessity of EU action

The AIFMD has been adopted in full respect of the principle of subsidiarity pursuing the objective to remove market fragmentation and address the risks to the financial stability that are inherently transnational. The Directive was a choice of instrument for finding an appropriate balance between EU-level and national action.

The proposed improvements to the AIFMD, which aim at completing this regulatory edifice with additional regulatory amendments and clarifications, aims to preserve the balance between harmonising key risk control measures and preserving Member State flexibility to continue regulating sub-threshold AIFMs that operate in a purely domestic environment or the distribution of certain types of AIF to retail investors.

Action at EU level must respect the principle of proportionality. Any amendments proposed will respect the principle of proportionality, as set out in Article 5 of the Treaty on European Union, and would not go beyond what is necessary in order to achieve the objectives of completing a Single Market for AIFs and contributing to the process of building the CMU, while ensuring a coherent approach to macro-prudential oversight of the EU AIF market.

The chosen options do not go beyond what is necessary to achieve the set objectives and are restrained in their level of interventionism. Where appropriate, new requirements imposed on AIFMs managing loan-originating AIFs are designed as general principles and more specific regulatory requirements would not unnecessarily disrupt existing business models (e.g., leverage cap which would be appropriate to limit the risks to the financial stability and would not interfere with the current prudent market practice). As regards investor protection, the proposed additional disclosure requirements are in line with the best market practice, which should be extended to all investors in the Union to ensure the same level of investor protection.

The proposals to enable cross-border access to the depositary services strikes the right balance between the AIF and investor needs and averting risks that may materialise without appropriate Union regulation of the depositary services.

The clarification proposed to the delegation regimes preserve the valuable features of these activities at the same time ensuring that there are requisite human resources provided to supervise the delegate and retain the core functions by an AIF or UCITS manager.

3.3 Subsidiarity: Added value of EU action

Harmonising requirements for the AIFMs managing loan originating AIFs should address risks generated by such funds to the financial system and at the same time facilitate internal market creation, which is currently fragmented by the differing national rules. Investors must be afforded the same level of protection regardless where the loan-originating fund or its manager is established in the Union.

The now expired transitional provision in Article 61(5) AIFMD, which allowed the necessary cross-border supply of depositary services, has already proven to add EU value, especially for smaller Member States. Therefore, finding a European solution to reopen the abruptly closed channels of such service flows is an imperative for the functioning of the internal market.

Attempts to ensure supervisory convergence regarding the delegation regime under the AIFMD and UCITSD have been exhausted. A legislative intervention is now required to clarify what the binding requirements are for the fund managers based in the Union that outsource their activities to third parties while still being considered as the managers of those investment funds.

These market wide effects can be achieved only by taking measures at the EU level.

4. Objectives: What is to be achieved?

4.1 General objectives

The general objective of the proposed improvements to the AIFMD is the same as of the original proposal for this Directive - to have a complete and consistent framework for the supervision and prudential oversight of AIFMs. Notably, the AIFMD pursues the objectives of ensuring financial stability, high protection of investors and an integrated AIF market. Managing micro-prudential risks is intrinsically linked to the macro-prudential risks, in particular where the AIF is large and interconnected with other financial intermediaries and thus able to generate and spread fund-level risk across the whole financial system.

4.2 Specific objectives

The proposed improvements would pursue the following specific objectives to:

- implement operational requirements for the managers of loan originating AIFs to ensuring that risks to financial stability are mitigated and investors are protected whilst levelling the playing field for those funds in the internal market;
- increase competition for depositary services provided to AIFs in those markets where there are a limited number of depositary service providers;
- improve effectiveness of the AIFMD and UCITS rules on delegation to ensure the necessary level of investor protection across the Union;
- improve supervisory reporting by providing supervisors with more granular data for market monitoring while removing the reporting duplications for AIFs and UCITS managers;
- improve the availability of LMTs for open-ended AIFs and UCITS across the EU;
- ensure the equal treatment of custodians upholding investor protection regardless of the type of entity that safe keeps AIFs' or UCITS assets.

5. What are the available policy options?

This section discusses the proposed policy choices for achieving three specific objectives: (i) implement operational requirements for the managers of loan originating AIFs to ensuring that risks to financial stability are mitigated and investors are protected whilst levelling the playing field for those funds in the internal market, (ii) to increase competition for depositary services provided to AIFs in those markets where there are a limited number of depositary service providers and (iii) to improve effectiveness of the AIFMD and UCITS rules on delegation to ensure the necessary level of investor protection across the Union.

Annex 6 contains technical proposals for achieving the remaining three specific objectives: (iv) to improve supervisory reporting by providing supervisors with more granular data for market monitoring while removing the reporting duplications for AIFs and UCITS managers; (v) to improve the availability of LMTs for open-ended AIFs and UCITS across the EU and (vi) to ensure the equal treatment of custodians upholding investor protection regardless of the type of entity that safe keeps AIFs' or UCITS assets. Given that the broad policy direction is clear with the technical proposals already provided by ESMA and/or ESRB, the debate in Annex 6 centres on the possibilities for the best technical execution.

5.1 Options to implement operational requirements for the managers of loan originating AIFs ensuring that risks to financial stability are mitigated and investors are protected whilst levelling the playing field for those funds in the internal market

Establishing a harmonised framework for managers of loan-originating funds would support overall stability of the financial system, while facilitating the development of an efficient loan origination sector across the EU with effective supervisory oversight and ensuring investor protection. Based on the analysis of national frameworks, there are certain common requirements imposed by certain Member States that could be adapted as a basis to develop similar requirements at EU level.

5.1.1 Option 1 and Option 2 discarded early in the process

Option 1 prohibiting AIFs from originating loans or participating in the credit market as direct lenders was considered early in the process and discarded as disproportionate and in conflict with the overall goals of the CMU to create new sources of finance for the real economy in Europe.

On a positive side, Option 1 would also remove the concerns that private credit markets are competing with the banking sector while subject to different rules leading to possible regulatory arbitrage opportunities. This approach would lead to a clear separation of function between financial intermediaries and the requirements attached to a particular licence, as it is not possible to subject close-ended loan-originating funds to capital requirements similar to those applicable to the credit institutions. The banking model creates liquidity mismatches on the banks' balance sheets because long-term, illiquid loans are provided mainly from the demand deposits, which can be redeemed daily. The closed-ended structure of loan originating funds mitigates maturity transformation as such funds are not vulnerable to redemption demands and can hold originated loans to maturity.

On a negative side, however, Option 1 would produce significant negative effects on the real economy. Loan originating funds provide a valuable source of alternative financing to Europe's corporates and SMEs, particularly to those that find it difficult to access more traditional sources of finance. Option 1 would reduce availability and access to finance with associated increased costs for the businesses. Therefore, this approach would also conflict with the objectives of CMU to develop alternative sources of financing for the real economy.

Moreover, a total prohibition for AIFs to originate loans would severely restrict economic freedom of AIFMs/AIFs and have an immediate impact on existing loan originating fund managers precluding them from engaging in new lending. Conversely, Option 1 would result in a more limited product offering and therefore have a negative impact on the investment choice for investors that are in search for a yield in low interest environment.

A total prohibition would have mixed effects on financial stability. On one hand, it would address the problem to financial stability by eliminating interlinkages with other parts of the financial system thus cutting the channels of potential contagion. On the other hand, loan-originating funds can provide an additional liquidity buffer or shock absorber in times of market stress. Prohibiting AIFs' taking up such a role would leave the financial markets more vulnerable.

Finally, pursuing this option would place European funds at a disadvantage in comparison to other international markets such as the US. Therefore, it was discarded at an early stage and not considered further.

Option 2 as a partial harmonisation of only certain measures modelled on the common elements of existing national frameworks was also considered at an early stage. This approach was discarded as it would not sufficiently address the potential risks to financial stability that the loan-originating fund sector may pose. Increasingly interconnected European financial markets require a sufficiently harmonised approach on a number of aspects, at a minimum those presented under Option 3 in the section below.

A partial harmonisation would suffer from significant drawbacks in terms of monitoring financial stability risks, particularly as the sector continues to grow in size and becomes a more important source of finance for the real economy. To prevent the emergence of new risks, it is important that the proposed EU rules establish a minimum number of safeguards regarding the funds activities and risk profiles. Based on the recommendations made by the ESAs and the potential risks highlighted in their research on loan-originating funds, a lighter framework would not fulfil the objective of supporting the continued development of this sector in a safe and sustainable way and would not fully address the issues raised by the ESA's in their feedback to the pubic consultation and other research that has been conducted.

While industry feedback is more mixed, there is general support for the overall objectives of the proposal – to improve the supervisory oversight of loan funds and protect against potential systemic risks. This element was acknowledged in subsequent follow-up consultations with industry stakeholders.

5.1.2 Description of Option 3

Policy option	Description
Option 3: Harmonise requirements for AIFMs managing loan-originating AIFs	a) Establish common EU rules allowing AIFs to originate loans but requiring AIFMs to develop robust credit assessment procedures, valuation methodologies and specific risk management frameworks to ensure sound credit origination b) Impose concentration limits, limit the funds inter-connectedness with the broader financial system and in particular credit institutions, and impose the closed-ended nature on these funds. c) Require retention of an economic interest when a loan is originated and sold by an AIF on the secondary market.

Option 3 proposes a set of comprehensive measures to address risks of loan originating AIFs as set out by the ESAs, including counterparty and credit risk and mitigating the potential risks of this alternative financing channel, level the playing field for AIFMs managing loan-originating funds and increase transparency around the activities of such funds. Whilst the AIFMD already contains requirements related to a fund managers risk management processes and reporting but these only cover standard fund risks such as liquidity, counterparty or broadly refer to 'other relevant risks'.

By establishing a harmonised set of EU rules based on the guidance of the ESAs and the potential risks highlighted in their research, loan originating funds would be able to originate credit in all Member States allowing them to scale up their funds and realise additional economies of scale and cost savings. This would increase the aggregate level of non-bank financing available in Europe leading to greater competition effects and association reductions in the cost of non-bank financing for borrowers such as SMEs.

Fund managers would have greater certainty about the regulatory requirements applicable to their loan origination activity which compares to the present fragmented landscape where there are different requirements in each Member State increasing compliance costs for managers and restricting cross-border investments.

This is also in line with the objectives of the CMU and the development of the Single Market to establish common rules across the Union and support supervisory convergence.

This proposal would add requirements for managers to manage credit risks effectively specific to their loan originating activities. Such credit risk specific requirements could include:

a) Organisational requirements

It would require the implementation of specific organizational requirements and policies to improve the robustness of the process of originating loans and the management of loan portfolios by AIFMs. Under this option, AIFMs would be required to ensure that the granting of credit is based on sound and well-defined criteria and that the process for approving, amending, renewing and re-financing credits is clearly established (including the risk management process to reassess and monitor the risk on an ongoing basis). AIFMs would be required to establish and regularly update procedures, policies and processes for the assessment, pricing and granting of credit as well as for credit monitoring. AIFMs would be required to use internal methodologies to assess the credit risk of exposures to individual obligors, securities or securitization positions and credit risk at the portfolio level under the supervision of their NCAs (authorisation process and ongoing monitoring).

b) Stress-testing

Level 2 measures regarding stress testing would be specified to require AIFMs to identify possible events or changes in economic conditions that could impact the AIF's credit exposures and improve the fund's resilience to market shocks.[72] AIFMs would be also required to take into account the principal market risk factors for such funds, including interest rates, FX and credit spreads in order to identify and address outsized concentrations in specific directional risks. The potential liquidity risks caused by maturity transformation of loan funds and the illiquid nature of their loan portfolios should be better captured in reporting with appropriate risk management and stress-testing put in place.

c) Risk retention requirement

To avoid moral hazard, AIFs that directly engage in loan origination should be required to retain a degree of economic interest in the loans they originate if they subsequently sell those loans on to another party. However, AIFs that only purchase loans on the secondary market and subsequently sell those purchased loans would not be required to retain a portion of the risk as they did not originate the loans.

d) Limit inter-connectedness with the broader financial system

[72] Article 48 (2) AIFMR.

Furthermore, as recommended by ESMA[73] and to ensure the independence of the funds activities and limit inter-connectedness with the broader financial system, in particular traditional credit institutions, AIFs should not be permitted to lend to:

a) the AIFM, management company, general partner, depositary, or to delegates or group companies;
b) other financial institutions.

Data from Lipper (2011) and the ECB show that in 2013, 18 out of the 25 largest asset managers in the EU are run by banks. Commission services calculations based on ECB data on investment funds (Q1 2021) and the Orbis database show that, as of Q1 2021, at least 43.7% of all investment funds in EU27 having a management company are managed by companies that are part of banking/insurance groups.[74] Given that since the late 1990s banks have been diversifying into non-interest earning activities such as asset management (the trend is global, but particularly pronounced in Europe), such structural ties serve as potential channels of contagion. The failure of a large loan-originating fund could pose a systemic risk to the extent that it is interconnected with other components of the financial system and in particular, credit institutions or fiduciary investors either through the loan portfolio itself, or the provision of backstop credit facilities. To contain the potential for such contagion, AIFs should be limited to originating loans to financial intermediaries by respecting a concentration limit of, for example 20% for a a single borrower, which is another financial institution.

e) Impose a closed-ended fund structure

To prevent excessive liquidity transformation risk, loan originating funds should be closed-ended. This would avoid the impact of redemption pressures particularly under stressed market conditions.

f) Investor disclosures

AIFMs would be required to provide investors periodically with the specific information on the AIF loan portfolios. Such reports would include a breakdown of: a) the originated loans debt classes; b) the amortising and bullet loans; c) the loan to value of each loan. Information on non-performing loans and loans subject to forbearance should be included in such reports. Investors should be also informed without delay of any material changes to credit assessment and monitoring processes. This would keep the investors well informed about the activities of the fund and permit supervisors to better monitor the evolution of risks to the financial system associated with the activities of loan originating AIFs. In addition information on AIFs loan portfolio could be useful to feed European Single Access Point (ESAP) for financial and non-financial information publicly disclosed by companies.

g) Transparency

[73] Additional information cf. Annex 7.
[74] However, this represent a lower limit and a downward biased estimate which implies that the real interconnectedness is much higher as it is based on direct upstream ownership links where the asset management companies were part of banking/insurance groups or having a global ultimate owner that is a banking or insurance company. Further to this, contractual relationships are other forms of interconnectedness that were not considered and more difficult to identify.

AIFMD reporting will be further detailed to provide regulators with additional information on loan origination (cf. infra, section on amendment to the AIFMD supervisory reporting requirements in Annex 6).

Feedback to the public consultation: Just over half of the respondents to the public consultation did not have an opinion on whether there is a need to harmonise requirements for AIFMs managing loan-originating AIFs. This group included the largest industry associations.

23% of the respondents opined that no further rules are needed, while 7 out of 10 Member States represented by the public authorities replying to the public consultation agreed that there is a need to harmonise at EU level the requirements for AIFMs managing loan-originating AIFs. They considered that Union rules are necessary to level the playing field and address the risks that may arise as a consequence of this activity

The authorities, however, expressed their support selectively for different elements of the discussed option. For example, imposing leverage limits (2 MS), restricting marketing of loan-originating AIFs to professional investors only (2 MS) or imposing diversification (2 MS) and concentration requirements (3 MS) were supported by different public authorities (for more results of the public consultation see Annex 2).

One dissenting industry association, however, favours a continuous reliance on the existing AIFMD framework without adding further statutory restrictions for AIFMs of LOFs. In their view, the AIFMD rules on resourcing, organisational and operational requirements, risk management, investment due diligence requirements, as well as rules designed to cover risks related to, for example, liquidity and leverage already suffice.

According to that respondent: (a) the structures of private credit funds are closed-end, or funds apply closed-end features to semi open-ended funds that do not redeem investors before maturity; (b) typically there is no more than one unit of debt for one unit of equity in a credit fund. In other words, the leverage rarely exceeds 100% of the funds' NAV (equivalent of equity); (c) interconnectedness should not be overestimated as in the most optimistic scenario where the size of private credit industry could increase six-fold to € 1.5tn by end of 2030, it would still be 24 times smaller than the €36tn EU banking sector.

5.1.3 The impacts of the retained Option 3

PROs: Measures proposed under Option 3 focus on addressing micro and macro prudential risks taking into account the specificities of loan originating AIFs and are aligned with elements of the established national frameworks. Proposed targeted restrictions on the activities of loan originating AIFs would support financial stability and limit the potential spill over effects to other parts of the financial system. The internal processes would be upgraded, which would contribute to a sound management of loan portfolios. In addition, transparency about the activities of loan originating AIF for both investors and regulators would be increased.

The proposed measures would not be at odds with the current market practice but would tackle managers that fall out or could fall out of the best practice and thus pose more significant micro or macro risks.

CONs: This option would entail costs for AIFMs that manage LOFs unconstrained by the rigor of internal processes and procedures for a sounds credit origination. Transparency requirements would also add some costs to those AIFMs, which are not divulging portfolio composition to other than their investors.

Impact on investors	• Positive impact on the investment choice for investors in search for a yield in low interest environment. • Better managed loan-originating AIFs with the adequate internal credit issuance and monitoring processes and procedures are likely to result in better investment outcomes for investors. • More transparency for investors about the activities of loan-originating AIFs enabling more informed decision-making.
Impact on AIF/AIFMs	• Substantial compliance efforts and costs for costs for AIFMs that manage loan-origination funds unconstrained by the rigor of internal processes and procedures for a sounds credit origination. • Adjusting activities to respect the legal limits in terms of various restrictions. • Costs to adhere to the transparency requirements. • Opening up growth opportunities by further integrating loan-originating AIF market.
Impact on financial stability	• Positive impact on the financial stability as the AIFMs of loan originating AIFs would be expected to engage in sound loan origination. • Limited potential contagion to the other parts of the financial system.
Impact on SMEs	• Establishing a harmonised framework will facilitate greater activity and increase competition in this sector as managers will have a consistent set of rules applicable across the Union. This will lead to the increased availability of credit for corporates and SMEs in the broader real economy including on a cross-border basis as more funds are launched and existing funds grow in size. • It could also reduce the cost of such financing for SMEs.

5.1.4 Comparison of the Option

This section compares the retained Option 3 against the objectives listed in Section 4. In addition, it assesses the efficiency of the Option and its impact on SMEs. The economic, environmental, social and fundamental rights impacts and coherence with EU policy objectives is also considered.

Objective	Option 3
Single market for AIFs	++ Harmonising requirements for loan originating AIFs across the Union contributes to creation of the AIF Single market and would potentially offer scaling up opportunities for loan-originating AIF market.

	Wider choice for investors of available investment strategies
Investor protection	++ Strengthened investor protection due to the better managed loan originating funds and more transparency around their activities
Financial stability	++ Strengthened via sound credit origination and by containing risk contagion to the financial system
Efficiency (cost-effectiveness)	-- Substantial compliance efforts and costs for AIFMs if they have not had sound credit originating practices in place already Costs for all AIFMs adjusting activities to respect the legal limits in terms of various restrictions and to adhere to the transparency requirements
Impact on SMEs	+ SMEs are expected to benefit from this approach through the establishment of a stable and diversified supply of alternative credit to the market. Increased availability and competition between loan originating funds will increase the availability and lower the cost of credit, particularly for SMEs and other corporate entities in Member States where this activity is currently prohibited.
Other economic, environmental, social and fundamental rights impacts	++ Increasing availability of alternative sources of financing to the real economy LOFs' activities in the credit market are likely to facilitate transition to the sustainable future by investing in green economy
Coherence with EU policy objectives	++ Aligned with overall CMU strategy to continue building internal market for financial services and with the objectives of the European Green Deal

Legend: +++ = Very positive ++ = Positive + = Slightly positive +/- = Mixed effect
0 = no effect - = Slightly negative -- = Negative --- = very negative

5.1.5 Costs

The introduction of a harmonised framework should not create significant new obligations as the AIFMD already requires effective internal processes for risk management. Measures specific to management of credit risk would normally form part of the overall internal/organisational costs related to the risk management and monitoring of the fund. The proposal would provide greater clarity and harmonisation of the risk management function. The adoption of a common/standardised approach is likely to reduce operational costs by providing greater clarity on the actual standards managers must apply and minimise additional 'undue' costs incurred from reporting or management that may be performed by managers due to the lack of clear guidelines but may not actually be required for effective risk management. Additional costs in this respect would likely concern AIFMs, which do not have sound credit originating practices in place already.

Given the potential risks such funds can pose, the benefits of introducing consistent requirements in terms of risk management process and procedures will outweigh the additional fund costs as this will ensure the better management of micro and macro level risks while decreasing the risks for investors and improving the effectiveness of the supervisory oversight of these funds.

Introducing concentration limits would require all AIFMs adjusting their managed AIFs' activities to respect the legal limits in terms of various restrictions. This may entail some costs but most of the AIFMs are likely to maintain internal systems to monitor and ensure respect for various investment and borrowing limits set forth in the fund documentation that they could use to adhere to the new restrictions. On the benefits side, these requirements would address the credit risk at portfolio level and mitigate an impact of a single event credit involving another financial institution on the entire portfolio of loans as well as contain risk contagion to the financial system.

These more detailed disclosure requirements would entail some costs for the AIFMs but these should not be significant and in any event justified by the policy objectives. Increased transparency of loan originating AIFs would have a positive impact on financial stability and investor protection. AIFMs would periodically communicate the composition of their loan portfolio so that the investors could appraise the risks and monitor the fund's performance. The same information communicated to the supervisors would provide the missing data that is necessary to monitor the development of the private credit markets and for making informed policy decisions.

5.1.6 Preferred Option

Option 3 suggesting to harmonise EU requirements for AIFMs managing loan-originating funds is the preferred option as it is the most effective and efficient for reaching the specific objective listed in section 4. It implies limited compliance costs, while ensuring coherence with the existing AIFMD rules on internal processes, risk management and reporting and with the general objectives of AIFMD to ensure financial stability, investor protection and AIF market integration. This Option is also coherent with the broader objectives of the CMU and the European Green Deal.

Loan originating funds provide a valuable alternative source of financing to the real economy, particularly for those entities that may not be able to access traditional lenders such as SMEs or where the costs of such finance are prohibitively expensive. The proposed harmonisation should facilitate the greater availability of attractively priced credit across the Union and increase market access for AIFMs, particularly in those markets that currently have total bans on this activity in place. Supporting the continued growth of this sector and maximising its contribution to economic growth and job creation in Europe is also consistent with the overall policy goals of developing the Single market for AIFs, the CMU as well as advancing European economy's green transition. However, it is preferred that the market of such alternative sources develops in a sustainable and safe way having the effective measures in place to address the emergence of new potential sources for systemic risk.

By establishing a harmonised set of EU rules, loan originating funds would be able to originate credit in all Member States allowing them to scale up their funds and realise additional economies of scale and cost savings. This would increase the aggregate level of non-bank financing available in Europe leading to greater competition effects and association reductions in the cost of non-bank financing for borrowers such as SMEs.

Proliferation of national frameworks for loan-originating funds has led to a fragmented regulatory landscape for managers and divergent supervisory approaches, which in isolation cannot guarantee the stability of the borderless financial system. Further harmonisation of requirements at EU level will effectively mitigate against new risks to financial stability that activities of loan-originating funds may generate. This would be achieved by increasing data flow to the supervisors enabling better market monitoring, limiting risk contagion to the financial system whilst preserving the ability of such funds to act as additional liquidity buffer or shock absorber in times of market stress and liquidity shortages. LOF do not need to maintain the same capital buffers as banks and this flexibility allows them to continue lending.

Finally, the preferred Option would serve investor interests best. The proposed measures would increase transparency of loan-originating AIFs and enabling harmonisation has the potential to facilitate growth of AIF market offering a choice of investment strategies that offer an attractive yield for investors in low interest environment.

5.2 Options to increase competition for depositary services provided to AIFs in those markets where there are a limited number of depositary service providers

5.2.1 Description of Options

Policy option	Description
Option 1: Create an EU depositary passport.	Propose common EU rules to create an EU depositary passport permitting a cross-border provision of such services.
Option 2: Allow NCAs to permit AIFMs sourcing depositary services across the border.	Maintain the general rule requiring the depositary to be based in the same Member State as the EU AIF. However, NCAs in smaller markets may permit AIFMs to source such services from the depositaries established in other Member States.

Option 1 would insert another building block into the internal market by creating an EU depositary passport, which would exist alongside the AIFM managing and marketing passports. This would allow managers to appoint a depositary regardless where it is situated in the EU. For its part, the depositary would be able to provide services on a cross-border basis. However, there is virtually no support for this Option (see stakeholder views in a text box infra), except from certain third country fund managers.

Stakeholder feedback to the public consultation: The vast majority of stakeholders share the concern that an EU depositary passport is likely to lead to a concentration of the depositary market in a few Member States with the increased significant risks for financial stability, which is considered undesirable by the potential hosts of such concentrated markets. A few stakeholders, mostly based outside the Union, expect the opposite, i.e. an increased competition and lower depositary serve costs (ILPA).[75]

Feedback to the public consultation shows that a large majority stakeholders (84.2%) either reject the idea of a depositary passport altogether, or see it as a long-term perspective (with a deeper EU harmonisation of the rules applicable to depositary service providers as being a prerequisite).

Respondents to the public consultation opined that 'in the event of a loss of the fund's assets, or any investor harm provoked by the depositary's negligence or misconduct, legal certainty can only be enhanced by having the depositary in the same jurisdiction as the fund allowing investors swift means of redress through any litigation and ultimately compensation' (EFAMA).

It is worth recalling, that the Commission proposal for the AIFMD contained a depositary passport, which was rejected by the Council and the European Parliament. Feedback from a number of Member States indicates that at least in the Council the majority still rejects this idea.

Option 2 proposes to enable a cross-border access to the depositary services for the AIFMs located in smaller markets where supply of such services is limited until the time when the EU law harmonisation reaches the necessary level to support the creation of an EU depository passport. The enabling provision could draw on Article 61 of the AIFMD, which contained transitional provisions to the same effect. Until 22 July 2017, NCAs were allowed to authorise the AIFs or AIFMs concerned to appoint a depositary established in another Member State.

This time the enabling provision will not be limited in time because it is disruptive for AIFs/AIFMs to have access to the services they need in the EU for a while and then abruptly fall into an illegal zone while practically still relying on the service providers located in other Member States.

Stakeholder feedback to the public consultation: Responding to the public consultation public authorities from the smaller depositary markets indicated their support for Option 2. Those not concerned do not harbour strong views.

5.2.2 The impacts of the Options

a) Option 1: Create an EU depositary passport

PROs: Option 1 would open-up supply of cross-border depositary services in all Member States. It is in the spirit of internal market and would be most effective in increasing competition in depositary market. Opening up market access for more players could bring down the costs of depositary services, which are ultimately borne by the fund investors, anywhere in the Union.

[75] ILPA: Institutional Limited Partners Association.

<u>CONs:</u> First, this Option would not be a proportionate policy response to the limited problem identified in the Evaluation, i.e. a limited provision of depositary services in a few smaller markets. It would mean a major overhaul of the AIFMD depositary regime, which is deemed to be working in most of the Member States efficiently and ensures a high level of investor protection.

Second, according to some stakeholder feedback, pursuing Option 1, may lead to new risks for financial stability and to their accumulation in a few jurisdictions if the depositaries were to concentrate there.

Third, it may have a potentially negative effect on investor protection. Introducing an EU depositary passport would mean that the AIF, the AIFMs and the depositary could be situated in three different Member States. Given the lack of the EU harmonisation of the different and relevant national rules, functioning and supervision of such a service triangle would be challenging to supervise with a potential detriment of investor protection. Notably, insolvency, securities law and fund accounting rules are national and relevant for, to mention but a few examples: (a) the sale, issue, re-purchase, redemption and cancellation of units or shares of the investment fund; (b) the calculation of the value of the units or shares of an AIF; (c) the instruction of the AIF to the depositary (e.g. in relation to the setting up and authorisation of a fund, the investment policy of a fund, the merging of a fund); (d) the distribution or reinvestment of an AIF's income. The depositary would have to know those rules and apply them correctly.

The NCA supervising the AIFM/AIF would need to supervise the depositary too otherwise supervision of the AIF/AIFM would be ineffective and vice versa. This means that the NCA would be required to know the regulation of the home Member State of the AIF or the depositary to supervise a correct application of the relevant rules. Investor protection could be harmed if the depositary or its supervisor would be unable to act properly and efficiently due to the above-mentioned challenges. Whilst some of the challenges described above could be overcome contractually between the AIFM and the depositary (e.g. with respect to fund domicile rules), other, however, are contingent upon a further harmonisation of rules at EU level prior to introducing of an EU depositary passport (e.g. supervisory set-up).

Consequently, considering the existing regulatory gaps, potential risks to financial stability and investor protection, introducing an EU depositary passport in this review would be disproportionate compared to the limited problem identified in the Evaluation.

For the different mentioned reasons 84.2% of stakeholders from the public and private sector expressed their disapproval of this Option.

Impact on depositaries	• Increased market access covering all the Member States creating business opportunities for the EU based depositaries. • Depositaries operating cross-border would be subject to a complex set of responsibilities as fund accounting, insolvency and securities laws are not harmonised in the Union.
Impact on AIFMs/AIFs	• Wider choice of depositary service providers potentially increasing effectiveness of service provision, including because of gaining access to the packaged services.

Impact on investors	• Investor protection may be undermined due to the difficulties for depositaries to comply with the different national laws in the key areas and for the NCAs to supervise service triangles scattered across the Union. • An EU depositary passport would increase supply of depositary services where supply is poor and reduce the fund costs, which the investors are ultimately to bear.
Impact on financial stability	• An expected depository market concentration in a few jurisdictions of the Union could negatively affect financial stability. A failure of a depositary holding a significant volume of the market's assets would have outsized implications for the financial stability. • Impractical cross-border supervision may lead to an overlooked risk accumulation.

b) Option 2: NCAs to permit cross-border sourcing of depositary services

<u>PROs:</u> Option 2 offers a targeted solution to address the problem of the limited supply of depositary service in some national markets with the least market disruption. It seems to strike the right balance between offering a solution to address the identified problem while minimising the potential risks to financial stability and investors. Option 2 enjoys majority support from the stakeholders that have expressed their views in the public consultation. Option 2 does neither define the term "smaller market" nor define which competent authorities are allowed to permit cross-border sourcing of depositary services. This Option provides sufficient flexibility to the Member States, which suffer from a lack of depositary services and identify risks for financial stability in their territory. As the depositary markets within the EU are very heterogeneous, any attempt to define a group of concerned Member States (e.g. linked to the number of depositaries, the Asset Under Management, or a ratio of both elements) would also capture Member States which do not suffer from a lack of depositary services. The positive experience with article 61(5) has shown that it was not necessary to define the concerned Member States and that this provision was used restrictively, i.e. only those Member States made use of the provision which suffered from a lack of depositary services.

<u>CONs:</u> Option 2 falls short of a perfect internal market solution but still represents a step forward in increasing the supply of the depositary services where the supply is weak._A potential negative effect on investor protection would concern a limited number of EU investments funds and would be justified by the objectives reasons. This Option would not produce outsized negative effects to the financial stability and actually would address financial stability concerns in the smaller markets.

Impact on depositaries	• Increased, whilst limited cross-border market access creating business opportunities for the EU based depositaries. • Depositaries servicing AIFs established in other Member States would be subject to a complex set of responsibilities as fund accounting, insolvency and securities laws are not harmonised in the Union, but the cases concerned would be limited.
Impact on	• Wider choice of depositary service providers where currently there is a weak supply side potentially increasing effectiveness of service

AIFMs/AIFs	provision, including because of gaining access to the packaged services.
Impact on investors	• No impact in most of the Member States. • Investor protection may be undermined in the Member States, where AIFs/AIFMs would be permitted to source depositary services across borders, due to the difficulties for the depositaries to comply with the different national laws in the key areas and for the NCAs of those Member States to supervise service triangles scattered across the Union. • In the permitting Member States where the supply side is poor, supply of depositary services could increase, which may reduce fund costs that the investors are ultimately to bear.
Impact on financial stability	• No impact at the EU level. • A positive impact in some Member States where the depositary market concentration is very high.

5.2.3 Comparison of the Options

Comparison table

This section compares the Options against the objectives listed in Section 4. In addition, it assesses the efficiency and their impact on SMEs. The economic, environmental, social and fundamental rights impacts and coherence with EU policy objectives is also considered.

Objective	Option 1	Option 2
Single market for AIFs	++ Completing an internal market for depositary services	+ Enabling wider choice of depositary service providers for AIFs/AIFMs from smaller markets would address the established problem of limited supply of such services in these markets.
Investor protection	- Investor protection may be weakened because of a complex set of responsibilities for depositaries arising due to the lack of Union harmonisation in the key areas of regulation	+- High level of investor protection is maintained as depositaries in most Member States continue to be based in the AIF domicile However, protection of some investors, which are invested in AIF located in smaller market

		where cross-border access to depositary service is permitted, may be weaker due to the lack of Union harmonisation in the key areas of regulation
Financial stability	- The concentration of depositary service providers in a few jurisdictions may amplify risks for financial stability	++ At the EU level: no effect as currently risks that could emanate from depositary service providers are dispersed At the level of some Member States with the smaller depositary markets: financial stability risks will diminish with the new market entrants.
Efficiency (cost-effectiveness)	+/- Increased competition is likely to reduce depositary costs in highly concentrated markets. Availability of packaged services is likely to increase service efficiency Complex supervision may be costly for all NCAs	+/- Increased competition is likely to reduce depositary costs in highly concentrated markets. Availability of packaged services is likely to have a positive effect Complex supervision may be costly but would concern a few NCAs only
Impact on SMEs	+ SMEs AIFMs are likely to benefit from this Option.	+ SMEs AIFMs are likely to benefit from this Option.
Other economic, environmental, social and fundamental rights impacts	0 No impact	0 No impact
Coherence with EU policy objectives	++ Aligned with overall CMU strategy to continue building internal market for financial	+ Aligned with overall CMU strategy to continue building internal market for financial services, however, taking an

	services	incremental approach

Legend: +++ = Very positive ++ = Positive + = Slightly positive +/- = Mixed effect 0 = no effect - = Slightly negative -- = Negative --- = very negative

5.2.4 Costs

Both options would reduce costs for depositaries and AIFs/AIFMs in more concentrated markets as the depositary would not need to take out another licence (a new depositary licence costs between € 6,000 – € 9,200 depending on a Member State) and would save on annual supervisory fees (between € 4,400 – € 9,400 depending on a Member State) in the Member States where the cross-border service provision would be authorised by the NCAs. AIFs/AIFMs would benefit from a wider range of services providers and increased price competition reducing their operating costs. Option 1 would capture a larger pool of depositaries although it is not clear how many in fact would avail themselves of the new business opportunities.

The supervisory challenges and costs associated to supervising depositaries, which are based in a different Member State from the AIFM/AIF, are likely to be substantial. Therefore, establishing an EU depositary passport would increase the costs significantly for the NCAs that would have to supervise depositary activities across the EU.

5.2.5 Preferred Option

Option 2 appears to be the most appropriate option. It would address the problem of the weak supply of depositary services in smaller markets in a targeted and proportionate way. It should increase competition among the service providers where there is the need. This should increase efficiencies in managing AIFs in smaller markets through potentially more competitive pricing and availability of packaged services. It will also lead to significant savings for the depositaries deciding to offer their services across the border, which otherwise would not be economical to provide.

In comparison to a full EU depositary passport, the retained option does not run a risk of creating outsized negative side effects, such as increased overall market concentration in a few jurisdiction thus potentially increasing significant risks to financial stability. An EU depositary passport, at this stage of the development of the Union law, is likely to complicate supervisory activities thus also jeopardising investor protection. It is also bound to come at a great public expense to ensure cross-border supervision. The discarded option is supported neither by the European fund industry, nor by the public authorities.

The retained option does not go beyond what is strictly necessary to address the problem and provides an effective remedy.

5.3 Options to improve effectiveness of the AIFMD and UCITS rules on delegation to ensure the necessary level of investor protection across the Union

5.3.1 Description of Options

Policy option	Description
Option 1: Specify further AIFMD and UCITS rules on delegation	a) Align UCITS framework with the AIFMD/AIFMR in the area of delegation. b) Further specify rules on delegation, notably requiring AIFM/UCITS to designate individuals who would be carrying out or supervising delegation of the key AIFM functions and identifying AIFM functions that cannot be delegated. c) Require NCAs forwarding to ESMA delegation notifications concerning an entire delegation of investment or risk management to the third country entities.
Option 2: Empower ESMA to enforce delegation rules	Empower ESMA to enforce delegation rules in the Union where the delegates are based in third countries.
Option 3: Impose a quantitative threshold	Establish a legal threshold on AuM managed by the third parties crossing which would signify that the AIFM or a UCITS manager has become a letter-box entity.

Option 1 would provide the lacking details to the AIFMD delegation regime and bring UCITS delegation regime to the same level. AIFMR contains concepts, which require further specification to ensure a uniform and effective enforcement of AIFMD rules against the establishment of letter-box entities in the Union. This Option proposes further defining the key areas, which fall under the responsibility of the AIFM's senior management and which cannot be delegated.[76] Furthermore, authorisation procedures would be clarified to require the designation of individuals responsible for the key managerial functions.[77] Those individuals engaged full time would be carrying out those functions in the AIFM/UCITS or oversee the delegates entrusted with those functions.[78] The same person would not be allowed to carry out and oversee the performance of certain functions. For example, the same person should not have oversight of the investment management function and risk management functions.

In addition, under Option 1, ESMA would receive and store notifications where investment or risk management is fully delegated to entities based outside the Union. Central gathering of such information would enable better analysis of the delegation activities by the European investment fund managers. ESMA then could assist NCAs in enforcing delegation rules under the AIFMD and UCITS legal frameworks in accordance with its existing powers to support closer supervisory cooperation and convergence.

[76] Article 82(1)(b) AIFMR.
[77] Specifying further Article 8 (1) (c) AIFMD at least two full-time equivalents (FTE) EU residents, which addresses secondment issues too.
[78] Article 82 (1) (a) AIFMR with regard to the expertise and resources retained within the AIFM to supervise the delegated tasks effectively and manage the risks associated with the delegation.

However, it would still be the responsibility of the NCA to approve delegation and enforce the delegation rules ensuring that the AIFM or UCITS comply therewith.

Stakeholder feedback to the public consultation: The majority of the respondents consider the delegation rules sufficiently clear to prevent the creation of letter-box entities in the EU. Some respondents wish for a further clarification whether a business practice falls within the scope of management delegation, since significant differences in the interpretation by the Member States exist. They consider that further clarification could be carried out by ESMA, providing guidance to enhance supervisory convergence and consistency.

A large number of respondents, among which 5 public authorities out of 12 that participated in the public consultation, would prefer more convergence on letter-box rules between AIFM and UCITS. The UCITS framework provides general statements on the impossibility of delegating functions, whereas the AIFM framework is more specific. In particular, public authorities stressed that the rules regarding delegating the performance of investment management should be clarified.

4 public authorities support defining core or critical functions that would be always performed internally and may not be delegated to third parties. 2 public authorities consider that AIFMs should not be allowed to delegate portfolio management and risk management functions at the same time. 1 public authority advocates subjecting fund depositaries to additional responsibilities to report on non-compliance with the rules on delegation and breaches from the delegate and two public authorities has no opinion.

Option 2 proposes to empower ESMA to enforce the AIFMD and UCITS delegation rules where the delegate is based in a third country. This Option would require equipping ESMA with all supervisory and investigatory powers akin to those currently available to the NCAs.[79] While this is likely to guarantee a uniform enforcement of the delegation rules in the Union, it would leave an AIFM with an increasing number of competing supervisors. ESMA would be added to a web of home and host NCAs, which are presumed to be able to carry out their supervisory functions effectively. Therefore, this Option may be judged as inefficient and disproportionate.

Stakeholder feedback to the public consultation: There was no specific question asked with regard to Option 2. However, 40,91 % respondents replied to the general question regarding enhancing ESMA's powers that there was no such need. However, 7 respondents supported the idea of ESMA being entrusted with authorisation and supervision of non-EU AIFMs and AIFs and 4 - with authorisation and supervision of all AIFMs, none of which are public authorities. 46,21% provided no answer.

Option 3 suggests putting in place quantitative thresholds in relations to the AuM delegated for management thus defining the exact point where an AIFM or a UCITS may be deemed to have become a letterbox entity and would no longer be considered a fund manager of a European fund. This would clarify the AIFMR rule outlawing delegation which would 'exceed by a substantial margin' functions performed by the AIFM itself and introduce such a requirement in the UCITS regulatory framework. However, such a threshold is likely to be impractical and lead to the detriment of the investor outcomes.

[79] A list of competent authorities powers are provided in Article 46 AIFMD.

Follow-up bilateral consultations with stakeholders regarding ESMA's letter proposing quantitative limits on delegation was extremely negative. Industry highlighted the benefits delegation brings to ensuring a wide range of product offerings for EU investors at competitive costs and ensuring the global competitiveness of Europe's fund industry where many managers rely on delegation as a key part of their management activity. Stakeholders reaffirmed their view that the AIFMD rules on delegation are generally robust and effective while accepting that certain clarifications are necessary.

Overall, this Option is deemed to be impractical, overly complex and of limited added value in the broader context of the current rules on delegation. There would be particular difficulties in setting the quantitative limits and assessing a manager's compliance with those limits. It would also be difficult for supervisors to monitor and enforce the regime. It could also be foreseen that such a rigid approach would generate a significant number of industry queries and possible Q&As, particularly regarding how the limits are calculated, situations where a manager temporarily trips the threshold or where managers were only marginally over the set limits. The overall complexity, burden and potential cost of this option outweighs its limited additional benefit to either investor protection or financial stability.

Stakeholder feedback to the public consultation: 42.42 % of the respondents, industry representatives, replied that there is no need to compliment AIFMR rules; 8 respondents, which are public authorities, had the opposite view and 36.36 % had no opinion. 3 public authorities supported the listing of core or critical functions that would be always performed internally and may not be delegated to third parties. ESMA in its letter to the Commission on the AIFMD review includes this element as a potential improvement of the AIFMD rules on delegation.

5.3.2 The impacts of the Options

a) Option 1: Specify further AIFMD and UCITS rules on delegation

PROs: Further specifying the substance requirements and identifying the relevant functions that must be retained by the AIF and UCITS managers licenced in the Union as suggested under Option 1 would create a better base for a uniform application of the AIFMD and UCITS rules against letterbox entities. Equipped with the relevant information contained in the received notifications, where risk or portfolio management is fully delegated to third parties, ESMA could effectively exert its current powers by assisting and advising NCAs in enforcing delegation regimes across the Union. This would ensure the same supervisory outcomes preserving level playing field for AIFMs and UCITS regardless of the place of their establishment in the Union. In turn, this should translate into the same level of investor protection across the EU. Moreover, Option 1 is a proportionate response to the identified issues and respects the principle of subsidiarity preserving the competences of NCAs.

CONs: Revising existing and new notifications of delegation arrangements will take time and could strain the current ESMA resources, although mostly at the beginning of notification process. In any event, Option 1 is much less resources intensive than Option 2 discussed below, under which ESMA would be enforcing delegation requirements in the Union instead of NCAs.

Impact on	• More clarity on the 'substance' requirements and hence increased legal

AIFMs	certainty. • Level playing field for AIFMs and UCITS regardless where they are established in the Union. • No compliance costs for AIFMs or UCITS based in the Union that are not letter-box entities.
Impact on investors	• Improved investor protection if the delegation requirements are better enforced hence ensuring that all the safeguards laid down in AIFMD/AIFMR and UCITS legal regimes are observed, including an effective monitoring of the delegate.
Impact on financial stability	• Better monitoring of the delegate is likely to lead to a more responsible investment management by the third parties lowering the probability of spillover effects to the financial system by a failed fund.
Impact of EU budget	• ESMA would not need additional resources to receive and process notifications with the delegation arrangements and carry out their duties in line with the current powers although it may feel a strain on its resources at start of notification process.

b) Option 2: Empower ESMA to enforce delegation rules

PROs: ESMA taking over enforcement of AIFMD and UCITS delegation rules would ensure that the Union laws have the same effect anywhere in the Union. It would preserve the same level of investor protection by ensuring that fund managers and funds, purportedly European entities, are not shell companies with the whole operation outsourced off-shore. This would also level the playing field for all the AIFMs and UCITS, which entrust some of their functions to third entities.

CONs: This Option may be judged as disproportionate to the issue identified and not respecting the principle of subsidiarity as there is no evidence that the NCAs are unable to enforce Union rules where those are sufficiently clear. It is uncertain whether ESMA would be equally effective in all the jurisdictions given differences of the national legal systems. It would require substantial increase of ESMA resources, thus, this Option is also expensive.

Impact on fund managers	• Level playing field for AIFMs and UCITS regardless where they are established in the Union. • No compliance costs for AIFMs or UCITS based in the Union that are not letter-box entities.
Impact on investors	• Improved investor protection if the delegation requirements are uniformly enforced hence ensuring that all the safeguards laid down in AIFMD/AIFMR and UCITS legal regime are observed, including an effective monitoring of the delegate.
Impact on financial stability	• Better monitoring of the delegate is likely to lead to a more responsible investment management by the third parties lowering the probability of spillover effects to the financial system by a failed fund.
Impact of EU budget	• ESMA would need significant increase in resources to take over the role of the sole enforcer of the Union delegation rules. • Accrued supervision on the implementation of the existing delegation

	requirements would be resources intensive.

c) Option 3: Impose a quantitative threshold

<u>PROs:</u> Specifying quantitative thresholds to clarify the AIFMR rule outlawing delegation, which 'exceeds by a substantial margin' functions performed by the AIFM itself, could bring additional clarity on legality of delegation arrangements. Implementing Option 3, therefore, could ensure a uniform enforcement of the Union law on delegation across the Union. This would require AIFMs to retain and reinforce their own resources, and would, incidentally, ensure a better supervision of the delegated activities.

<u>CONs:</u> The problem with imposing a hard threshold is that their inflexibility is likely to harm investor outcomes. In many instances, application of the delegable AuM threshold would be impractical and is likely to lead to the detriment of the investor outcomes.

For example, an equity fund holding 100% Asian equities is managed by an expert manager in Asia. In such a case the benefit for the European investors are clear: they can get exposure to other markets, diversify their investment portfolios and profit from the requisite expertise. All those benefits are provided in compliance with the EU rules, which are ensured by the local manager. Artificially splitting management of these assets by imposing a numeric threshold would mean that half of portfolio would be managed by a lesser expert only to satisfy the legal requirement but undermining the investor interests. Delegation can also allow managers to benefit from cost savings that then translate into lower fees for investors while supporting the competitiveness of Union fund managers and continued market growth in line with the goals of the CMU. The imposition of quantitative thresholds would also impose disproportionate limitations on fund managers ability to structure their operations cost effectively.

Therefore, Option 3 is judged as impractical given the diversity of investment strategies and investment goals. It is also difficult to determine at what point the threshold should be set and it would lead to difficult situations where a manager was close to the threshold (either above or below) leading to borderline cases where a small numeric difference could trigger the letterbox classification or not.

Impact on fund managers	• More clarity on the 'substance' requirements and hence increased legal certainty • Level playing field for AIFMs and UCITS regardless where they are established in the Union. • No compliance costs for AIFM or UCITS based in the Union that are not letter-box entities.
Impact on investors	• May have a negative impact on investor outcomes given the diversity of investment strategies and investment goals.
Impact on financial stability	• No notable impact.
Impact of EU budget	• None

5.3.3 Comparison of the Options

The following table compares the Options against the objectives listed in Section 4. In addition, it assesses the efficiency and their impact on SMEs. The economic, environmental, social and fundamental rights impacts and coherence with EU policy objectives is also considered.

Objective	Option 1	Option 2	Option 3
Single market for AIFs	+ Further clarification of delegation rules should foster their uniform interpretation and application levelling the playing field for AIFMs and UCITS based anywhere in the Union Ensured information flow to ESMA should support its coordinating role and facilitate a uniform enforcement of the delegation rules in the Union	++ ESMA would ensure uniform interpretation and enforcement of the current delegation rules levelling the playing field for AIFMs and UCITS based anywhere in the Union.	+/- Providing quantitative thresholds would contribute to a uniform interpretation of delegation rules levelling the playing field for AIFMs and UCITS based anywhere in the Union Enforcement of the delegation rules would remain exclusively national
Investor protection	+ Strengthened investor protection due to a better enforcement of delegation rules	++ Strengthened investor protection due to a better enforcement of delegation rules	-- Quantitative thresholds may undermine investor interests imposing artificial limits to the desired investment management
Financial stability	+ Strengthened indirectly because of monitoring pressure on the delegate is likely to result in better execution of the	+ Strengthened indirectly because of monitoring pressure on the delegate is likely to result in better management of	0 No impact; quantitative threshold is not an objective measure for quality of the investment management

	management of investments	investments	
Efficiency (cost-effectiveness)	0 No cost implications for the AIFMs and UCITS which, do not operate as letter-box entities	0 No cost implications for the AIFMs and UCITS, which do not operate as letter-box entities	- Potential cost implications for the AIFMs and UCITS to monitor compliance with the thresholds
Impact on SMEs	0 No cost implications for the SMEs AIFMs or UCITS, which do not operate as letter-box entities	0 No cost implications for the SMEs AIFMs or UCITS, which do not operate as letter box entities	-- Compliance burden for SMEs AIFMs and UCITS to monitor the compliance with the thresholds
Other economic, environmental, social and fundamental rights impacts	0	0	0
Coherence with EU policy objectives	+ Aligned with overall CMU strategy to continue building internal market for financial services and ensure strategic independence of the EU	++ Aligned with overall CMU strategy to continue building internal market for financial services and ensure strategic independence of the EU	- May hurt EU efforts to have effectively regulated internal market for financial services

Legend: +++ = Very positive ++ = Positive + = Slightly positive +/- = Mixed effect
0 = no effect - = Slightly negative -- = Negative --- = very negative

5.3.4 Costs

The clarifications envisaged in Option 1 would not have any cost implications for the AIFMs or UCITS management companies, which currently do not operate as letterbox entities, i.e. which already comply with the spirit of the AIFMD and UCITSD to have adequate human and technical resources to conduct the business of collective investment management. The envisaged substance requirements as clarified in the proposed amendments should have been implemented already to ensure a proper application of the AIFMD/AIFMR and UCITSD requirements.

Retaining Option 1 would entail only minor additional costs, if any at all, for supervisors since NCAs are already receiving notifications of delegation arrangements. NCAs will be in charge of reporting this information to ESMA. ESMA staff, which is currently processing reporting requirements, will be able to process this information without the need for adding staff to collect and process the received data. Any further supervisory engagement by ESMA on the basis of the collected information would be pursued on the basis of the existing powers and with already allocated staff.

Option 1 would be significantly less expensive to implement than Option 2, which would need to ensure that ESMA has the necessary resources to take on new functions. Option 1 would be also less costly than Option 3, which would entail significant costs for the AIF and UCITS managers and supervisors to monitor compliance with the established thresholds. In comparison to Option 3, Option 1 is practical.

5.3.5 Preferred Option

Option 1 is the preferred option as it is deemed to be the most practical and proportionate. At the moment, a fundamental change to the AIFMD delegation rules is not necessary and the legitimate use of delegation must be preserved. The proper use of delegation arrangements has clear benefits for EU managers and investors. Delegation allows EU managers to rely on the local expertise of the managers that operate in specific markets and have access to global trading capabilities.

Furthermore, having access to information on delegation practices, ESMA would be in a better position to support the NCAs enforcing delegation requirements and thus to effectively exert its current powers. This is also preferable to ESMA taking on full responsibility for enforcing the delegation rules under Option 2 because Option 1 is proportionate and respects the principle of subsidiarity absent the evidence that NCAs have not been effective in applying the rules, which are sufficiently clear. Option 1 will clarify the AIFMD and UCITS delegation rules to improve further understanding and compliance by industry as well as supervisory convergence.

Option 3 was proposed in ESMA's letter to the European Commission and would be supported by a few public authorities (for more results of the public consultation see Annex 2). However, this Option scores lower in terms of efficiency, effectiveness and would be overly burdensome. In addition, Option 3 would likely encounter a strong opposition from the fund industry as impractical and arbitrary.

6. PREFERRED COMBINATION OF OPTIONS

The preferred options were selected to facilitate and enhance the monitoring and management of micro- and macro risks, to further integration of the internal market and to ensure the same level of investor protection across the Union, while limiting the costs and potential negative side effects that the chosen options may entail.

6.1 General impacts

First of all, the options retained will have a positive effect on monitoring and managing risks to financial stability. Robust regime for AIFMs managing loan-originating funds would lead to better and coherent risk management at fund level within the EU, which in turn would reduce overall risks to financial stability. Reducing channels and extent of contagion would have a positive effect on financial stability. Interconnectedness of the financial market players can propagate potential losses in case of negative shocks that can be transmitted to the fund's investors, counterparties or other financial intermediaries and businesses and then to the broader financial system, thereby reducing the resilience of market participants.

The retained option on LMTs is coherent with the AIFMD regulatory framework, which sets forth a general requirement to have liquidity management policies and procedures in place Open-ended fund managers having access to a wider range of LMTs would be able to manage liquidity risk more effectively and avoid forced selling thus amplifying impact of financial market turmoil. NCAs, similarly, will have a wider range of tools to activate depending on the market situation, serving financial stability needs and also preserving investment value in the times of stress. Improving data granularity for NCAs, including data on loan originating market, would permit a better monitoring of the risk accumulation in the system and emerging macro trends, thus being able to time better a supervisory intervention where necessary. The combination of the retained options therefore would achieve the primary objective of the AIFMD, which is to ensure stability of the financial system.

Secondly, in addition to realising the imperative of financial stability, the retained options would increase efficiency of the EU AIF market. Whilst AIMFs would be subject to harmonising standards, loan-originating AIFs would be able to originate loans anywhere in the Union, which is currently an activity either outlawed or restricted to local funds only. A liberated ability by AIFs to provide credit in a sustainable manner would increase available funding for the real economy and in particular to the SMEs, which often struggle to secure credit from the banks. A vibrant, yet orderly, private debt market will be key in advancing the Union's transition to a more sustainable future.

Furthermore, AIFMs/AIFs established in smaller markets could access a wider choice of depositary services, which expectedly would include efficient packages of services and at a more competitive price increasing. This would increase efficiencies in fund management and produce better returns for investors. The retained option may have a side effect of promoting fund market development in certain jurisdictions thus increasing investor choice.

Thirdly, the retained options would enhance investor protection across the Union. Clarifying rules on delegation would ensure that the fund managers have sufficient human resources in the Union to monitor the activities of the delegate and that these standards are common in all the Member States. The proposed measures would be effective in terms of attaining the pursued objective without generating unjustified costs for the fund managers. Levelling the regulatory standards for UCITS and AIFMs in this respect would bring about the missing coherence between the two legal frameworks as there is no convincing explanation for why these differences should exit.

Similarly, the investors would be better protected if the depositaries were in a position to discharge their duties as prescribed in the AIFMD regardless of the type of licence under which a particular custodian of the funds' assets is operating. To this effect, the proposal would recognise all custodians, including CSDs, as a part of the custody chain subjecting them to a statutory obligation to share information with the depositary on the funds' assets they safe keep. This would effectively ensure the level of investor protection as sought by the Union co-legislators. In the same vain, investor interests would be more effectively protected by the proposal requiring fund managers to provide a certain profiling of the portfolio loans of a LOF.

The options, which would have affected the supply of the credit to the market to the detriment of business seeking capital injections, options that would be disproportionate or impractical, were discarded. The retained options offer improvements to the AIFMD that would further support financial stability, investor protection and further market integration by means of proportionate and practical measures. The retained package of options would strengthen AIFMD and UCITSD in terms of efficiency and effectiveness of these two legal frameworks. They also increase coherence between the two Union laws where the divergences are hard to justified, like in the area of delegation, asset safekeeping by CSDs, supervisory reporting requirements and availability of LMTs.

Nevertheless, some of the chosen options may entail compliance costs, with a clear exception of the policy response to increase access to depositary services, which offers significant savings for the depositaries and AIFs/investors.

Consistency with other Union laws

The proposed measures would impact the AIFMs managing AIFs governed by Regulation on European long-term investment funds (ELTIFR) and to a very limited extent venture capital funds following Regulation on European venture capital funds and Regulation (EuVECA) given very specific product rules laid therein regarding eligible investments. ELTIFR is a European product regulation, which is being reviewed in parallel with the AIFMD.

AIFMs managing ELTIFs are likely to benefit from a facilitated access to depositary services cross border, if those funds are located in smaller markets. An envisaged work on improving supervisory reporting requirements would have a positive effect on compliance burden of AIFMs managing ELTIFs in a longer run. Changes to the AIFMD regarding the use of liquidity management tools, which concern fund managers of open-ended investment funds, would have no direct impact on AIFMs managing ELTIFs, which are closed-ended type of investment vehicles. Including CSDs into the custody chain would have a positive effect on investor interests, however, only with respect to the proportion of the ELTIF's holdings, which could be held in custody by the CSDs.

The most obvious interaction of the ELTIFR and the amended AIFMD will concern loan origination activities, which are governed by the product rules of the former and would see some general principles imposed by the AIFMD on AIFMs active in credit markets. For those ELTIFs that can be marketed and distributed to retail investors thus the stringent requirements, which already exist within the ELTIFR, will be applied. The proposed thresholds for lending to the financial institutions are aligned with the diversification threshold applicable to those ELTIFs that are only marketed to retail investors. To make the AIFMD future and interpretations proof, the provision should be proposed that would require application of the ELTIF, EuVECA and EuSEF product rules as *lex specialis* where those may conflict with the more general provisions of the AIFMD.

6.2 Cost implications

AIFMs, which give effect to the general principles of the risk management as laid down in the AIFMD and AIFMR without being guided by the specific rules addressing the risks pertaining to the activities of LOFs will not bear significant costs. The same would apply to AIF and UCITS managers that, whilst delegating risk or portfolio management to third entities, ensure that they employ enough staff to control the delegate and make sure that the delegate carries out the mandate in line with the agreed terms and respecting the fund rules as well as the relevant legislation. A large part of the managers will be unaffected by the proposed clarifications. Under the current rules, AIFMs notify NCAs about their delegation arrangements, therefore, an insignificant cost of NCAs' forwarding this information to ESMA will not burden the fund managers.

Working towards more granular reporting requirements will not lead to any costs at this stage. At the later stage, if and when the discarded option is pursued, migrating to a streamlined supervisory reporting template may entail one-off costs for adjusting internal systems (significant costs) and procuring and maintaining LEI (€50-80 per year), but these should be quickly offset by the introduced efficiencies whereby an on-going compliance with the reporting requirements would be optimised. Instead of reporting to two public authorities under two different templates, fund managers would report to a central point the data required under a single template. As described in the relevant section, feasibility of the ultimate template must be assessed by the public authorities concerned before establishing a concrete estimate of the future costs.

At this stage, however, it is not possible to calculate precisely the amount of costs that will be generated by changing the AIFMR reporting template before we receive a feasibility study from ESMA involving other ESAs and the ECB, which the proposal would mandate. The feasibility report will provide these figures taking into account the overlapping fields and the reporting needs of different public authorities making it possible to provide an indicative expense of potential changes for AIFMs and UCITS.

Bringing CSDs into the custody chain will entail limited one-off cost of revising the contractual relationship between the depositaries and the CSDs. It is reminded that a depositary is obliged to have a contractual relationship with all its delegates.

Costs linked to the revision of the contract are justified costs to ensure that a robust depositary regime is effective and depositaries are able to follow through their mandate regardless of the type of a custodian safe keeping the funds' assets.

Requesting a manager of open-ended AIFs and UCITS to choose an LMT that they could activate in the time of stressed market conditions would require changes to the fund documentation (including prospectus) for some products, which currently do not have such tools included therein. In the most extreme scenario it may mean € 40 000 cost per product. There are 29 000 UCITS funds, which are open-ended as per statutory requirements, and 66% out of 32 585 AIFs are open-ended, that is 21 506 AIFs. It is not possible to calculate an aggregate cost for the industry as there is no precise information on how many funds already have LMTs envisaged in their fund documentation. A general practice to review the fund documentation once a year due to various other regulatory requirements should be also considered. It can be, however, assumed that the benefits to the financial system justify these one-off costs as the fund managers will be able to manage the liquidity risk more effectively and refrain from fire sales under the stressed market conditions thus exacerbating already dire market situation.

The retained option addressing a weak supply of depositary services in the smaller markets would generate significant savings for the depositaries willing to offer cross-border services without incurring one-off cost for new licence and annual licence costs that range respectively between € 6,000 – € 9,200 depending on a Member State and between € 4,400 – € 9,400 depending on a Member State. If 5 to 10 depositaries would offer their services in the smaller markets following implementation of the activated option, it would result in € 30 000/60 000 – € 46 000/92 000 aggregate savings of one-off-licence costs and € 22 000/ 44 000 – € 47 000/ 94 000 for annual licence costs. The increased competition among service providers is likely to exert downwards pressure on the service price. Whether these predictions materialise will have to be assessed in the next evaluation.

6.3 Impact on SMEs

SMEs stand to benefit from this review, notably from the harmonisation of requirements for AIFMs managing loan-originating AIFs. Apart from facilitating efficiencies in managing such AIFs', the retained option aims to enable AIFs to extend credit to businesses across the border. In some Member States AIFs are not allowed to originate loans or this right is reserve to locally established funds. This review would further integrate the LOF market and would create more business opportunities for the LOFs consequently opening up alternative sources of financing for SMEs in particular where they are unable to secure credit from the banks or where loan originating funds are currently prohibited from operating. Small companies and start-ups involved in green technologies are likely to feel the benefit of availability of financing thus participating in the green transition.

6.4 REFIT (simplification and improved efficiency)

The proposal aims to reduce or minimise any additional regulatory costs for investment managers. Increasing access to depositary service providers is designed to increase the range of providers accessible to managers particularly those in smaller markets where there is a lack of price competition and packaged service offering.

With regard to the other proposals, it is likely that AIFMs managing LOFs will face additional costs due to the new risk management requirements to account for the specific credit risk these funds face. It is important to note that these requirements are based on the existing national regimes so managers that are currently engaged in effective risk management of their credit portfolio under those regimes should not incur significant new costs. However, managers that do currently manage their credit risk effectively may incur costs to meet the requirements but these are deemed proportionate and necessary in the interests of financial stability and investor protection.

While the KMPG reported indicated that there have been general increases in compliance costs, this was not among the core issues identified through the public consultation or subsequent bilateral engagements. Rather, stakeholders indicated that they had invested significantly in their reporting and compliance systems to meet the requirements of the AIFMD.

Apart from the depositary costs, it is difficult to quantify the precise cost impact of the proposed measures as compliance costs vary between fund managers depending on their location, organisational structure, fund size, choice of service providers and the complexity of their investment strategies. In addition, fund level cost data is generally confidential information not widely shared by investment managers.

The harmonisation of LMTs may lead to one off costs for managers in jurisdictions where the funds legal documentation must be updated. However, this is deemed proportionate to allow for the more effective management of liquidity risk. New funds that are completing their initial registration should not incur any new costs as the additional LMTs will be part of their application.

More granular data reporting should be implementable through existing reporting systems with only minor administrative costs to add the new data fields. Again, this is deemed proportionate given the need to ensure effective supervisory oversight and reporting of fund specific and market developments.

The additional requirements related to delegation may lead to additional costs for certain funds that currently do not have the necessary FTEs responsible for oversight of their delegates. However, the proposed change is a clarification of an existing requirement under the AIFMD so should not lead to significant new costs for managers. Any additional costs are deemed to be proportionate to the need to ensure adequate levels of investor protection and to protect against potential stability risks where managers misuse delegation.

REFIT Cost Savings – Preferred Option(s)		
Description	*Amount (in €)*	*Comments*
Enabling cross-border sourcing of depositary services	Potential saving of up to 30 000/60 000 – € 46 000/92 000 for one-off-licence and € 22 000/ 44 000 – € 47 000/ 94 000 annually by depositaries	According to the KPMG study on the scope and functioning of the AIFMD one-off licence cost and annual licence costs that range respectively between € 6,000 – € 9,200 and between € 4,400 – € 9,400 depending on a Member State. If 5/10 depositaries would offer their services in the smaller markets following implementation of the activated option, it would result in mentioned aggregate savings (€ 30 000/60 000 – € 46 000/92 000 aggregate savings of one-off-licence costs and € 22 000/ 44 000 – € 47 000/ 94 000 for annual licence costs.)

7. How will actual impacts be monitored and evaluated?

The supervisory reporting data under the AIFMR, when additional data that would be required to be provided by AIFMs to the NCAs and ESMA following the adoption of the proposed amendments, would allow them to monitor and evaluate the actual impact of the proposed amendments. The collected information on the private credit market and on the types of originated loans will allow conducting analytical work by NCAs, ESMA and the Commission. Data from trade associations and from individual market participants will complement the official sources of information.

The primary factors to monitor will be the size of the EU AIF market originating loans in terms of AuM and the number of such AIFs, the loan portfolio compositions breaking down the types of loans and the use of leverage by such funds. Measuring cross-border activities of such funds will be instrumental in ascertaining whether the harmonisation measures have created an internal market for the EU loan originating AIFs.

The number of Member States using the possibility to allow sourcing the depositary services and the number of such service providers available in the smaller markets as well as the impact on depositary costs should be monitored and evaluated to appraise the effects of the adopted improvements. It will be requested ESMA to expand the scope of its annual statistical report on the cost and performance of European Union (EU) retail investment products to include depositary fees for investment funds.[80] The changes in depositary services market in smaller markets will be obtained by using commercial data and running a general survey.

Receiving data on delegation arrangements submitted to ESMA would allow producing analysis on the usage of these arrangements in terms of geographical location of the delegates and evaluate whether investor interests are well protected by the laws of the jurisdictions where the delegates are located.

An evaluation of this initiative will be carried out five years after its entry into application.

Objective	Indicator	Source of Information	Data already collected?	Actor(s) responsible for collection
Cross border access to depositary services for smaller markets	Number and market share of depositaries offering services in smaller markets	Supervisory reporting data/ ESMA reporting	No	ESMA/NCAs
	Level of fees charged to fund managers in smaller markets		No	
Clarify legal requirements of delegation regime	Number of Q&As received	ESMA reporting	Yes	NCAs
	Number of ESMA advisories issued to NCAs			
Harmonisation of Liquidity Management Tools	Implementation of LMTs in domestic fund rulebooks and legal documentation	ESMA reporting	Yes	ESMA/NCAs

[80] Retail clients continue to lose out due to high investment products costs (europa.eu)

	Number and type of LMT activations			
Harmonise EU requirements for AIFMs managing Loan Originating Funds	Number and size of loan originating funds	ESMA reporting	Partly	ESMA/NCAs
	Number of MS in which loan originating funds may extend credit			

ANNEX 1: PROCEDURAL INFORMATION

Lead DG, DEcide Planning/CWP references

Directorate-General for Financial Stability, Financial Services and Capital Markets Union.

PLAN/2019/6271

Organisation and timing

The initiative is included in the Commission Work Programme 2021.

Consultations

Inter-service Steering Group (ISSG)

The first ISSG meeting took place on 18 September 2020 with the attendance of the representatives from the following Directorates-General (DGs) of the European Commission: Competition; Economic and Financial Affairs; Taxation and Customs Union; Justice and Consumers; Internal Market, Industry, Entrepreneurship and SMEs; Climate Action; Secretariat General; Financial Stability, Financial Services and Capital Markets Union. There were three more ISSG meetings that took place on 9 April 2021, 5 May 2021 and 10 June 2021.

Consultation of the Regulatory Scrutiny Board

An upstream Regulatory Scrutiny Board (RSB) meeting took place on 19 May 2021. The RSB members made the following recommendations:

- It is important to consider carefully the presentation of the impact assessment, as this is a highly technical file. The report should be a digestible document with a clear and strong context description of the AIFMD that sets the scene for the (uninformed) reader.

- In this context, Board members invited DG FISMA to develop a clear narrative that presents the real options and policy choices for the decision makers. They recalled the need to find a good balance between issues covered in the main text and the annexes.

- Board members recalled the need to clearly present and define the problem drivers, regulatory failures and gaps, providing evidence of the existence and magnitude of the problems. Evidence should be provided to demonstrate the level playing field issues.

- Board members advised to be clear on the role of ESMA's recommendations. The report should be transparent about the extent to which the options follow or deviate from ESMA recommendations. The analysis should focus on where the latter is the case. Similarly, the options and corresponding analysis should be clear on and address potential diverging positions of stakeholders.

- The report should make clear whether the options are complementary or alternative to each other. If there is a lack of alternative options, the report should explain why. If the report concludes on a preferred option that is a combination of measures from different options, the impacts of the combination should be clearly analysed.

- Board members recalled the importance of integrating stakeholder views throughout the report. Stakeholder views should be disaggregated, with a clear overview of agreements and disagreements and how these are addressed.

- Board members invited the DG to keep the 'one in, one out' principle in mind, especially as this is a REFIT initiative. The report should pay particular attention to identifying new costs and cost savings stemming from simplifications of the current Directive. A clear overview should be provided on compliance and administrative costs, and how these balance off with the foreseen benefits. While full quantification of costs and benefits is often not available, the report should be transparent on quantification limitations. Qualitative evidence can complement the lack of quantification.

The consultation of the Regulatory Scrutiny Board (RSB) took place during the meeting on 14 July 2021.

The Board's recommendations on the impact assessment are summarised as follows:

Consultation with the Member States

- On 27 September 2019 and on 27 November 2020 the Commission consulted the Expert Group of the European Securities Committee (EGESC).

- On 17 of March 2021 the Commission consulted the Financial Services Committee (FSC) of the Council of the European Union.

- The Commission engaged with the NCAs and ESMA staff in ESMA Investment Management Standing Committee.

Evidence, sources and quality

In line with the general principles in the Better Regulation guidelines on the need for evidence-based impact assessments, this impact assessment is based on the following data and information sources:

- European Commission's report dated 10 June 2020 assessing the scope and the functioning of the AIFMD (COM(2020) 232 final) and respective Commission Staff Working Document (SWD(2020) 110 final) assessing the application and the scope of the AIFMD.
- KPMG Report on the Operation of the Alternative Investment Fund Managers Directive (AIFMD) – Directive 2011/61/EU dated 10 of December 2018.
- Feedback to the Public consultation of the AIFMD review published on 22 October 2020 containing 102 questions on various aspects of the AIFMD review.
- Takeaways from a virtual conference on the AIFMD review organised on 25 November 2020 involving MEPs, NCAs, ESRB, ESMA, representatives of the industry and investor interests.
- ESMA letter dated 18 August 2020 to the EVP Dombrovskis regarding Review of the Alternative Investment Fund Managers Directive.
- ESMA Annual Statistical Report EU Alternative Investment Funds 2019 and 2020.
- FSB Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities dated 12 January 2017 and Vulnerabilities associated with leveraged loans and collateralised loan obligations (CLOs) dated 22 November 2019.
- IOSCO Final Report on Recommendations for Liquidity Risk Management for Collective Investment Schemes of February 2018.
- Recommendation of the European Systemic Risk Board of 7 December 2017 on liquidity and leverage risks in investment funds ESRB/2017/6, 2018/C 151/01.
- Documentation surrounding the CMU Action Plan, including the Communication from the Commission on "Capital Markets Union: Progress on Building a Single Market for Capital for a Strong Economic and Monetary Union" dated 15 March 2019.
- Analysis of academic and commercial publications on the topic of the practical issues pertaining to the functioning of the AIFMD framework.
- Market data on the size, asset flows and respective stakeholders in the area of alternatives by using Morningstar and the SAFE SURVEY.
- Publicly available reports, studies, surveys, position papers and other relevant documents drawn up by private and public stakeholders.

- Input from workshops, bilateral meetings and consultation with Member States and industry stakeholders, including asset managers, product manufacturers, retail investors' representatives and investment funds active in alternatives investment.

ANNEX 2: STAKEHOLDER CONSULTATION

On 22 October 2020 a public consultation on the AIFMD review was published containing 102 questions on various aspects of the AIFMD review. It closed on 29 of January 2021 yielding 133 responses. A snapshot analysis of the feedback on the issues addressed in this impact assessment is presented, including responses to the questions on a) delegation regime; b) regulating AIFMs managing loan-originating AIFs; c) harmonisation of LMTs.

Chart 1 – Type of respondent

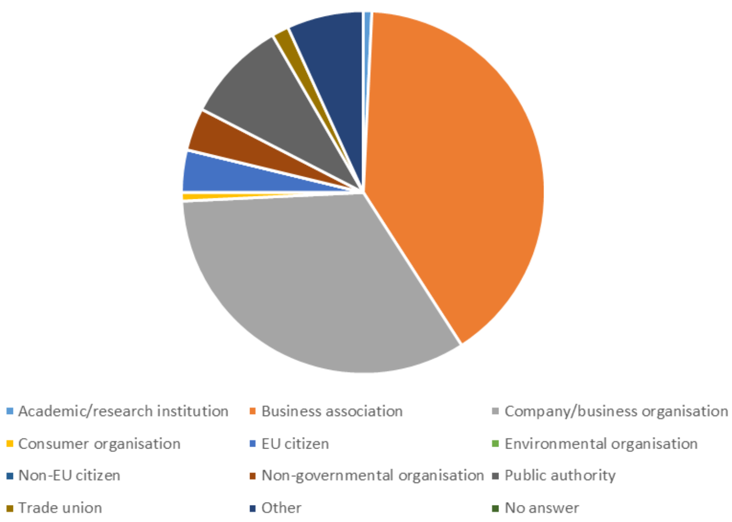
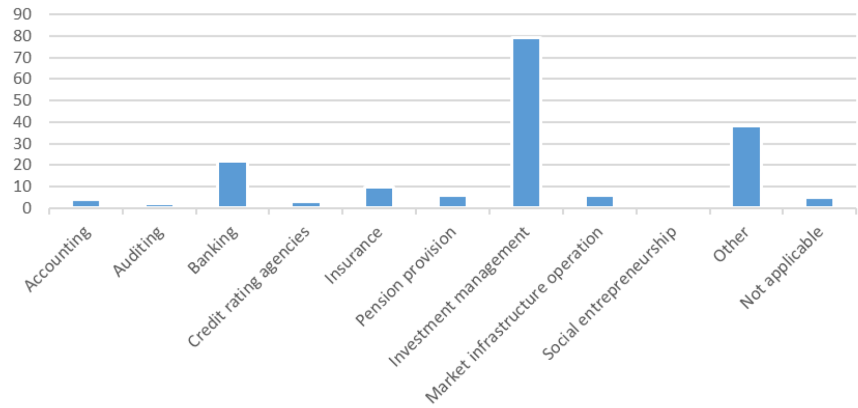
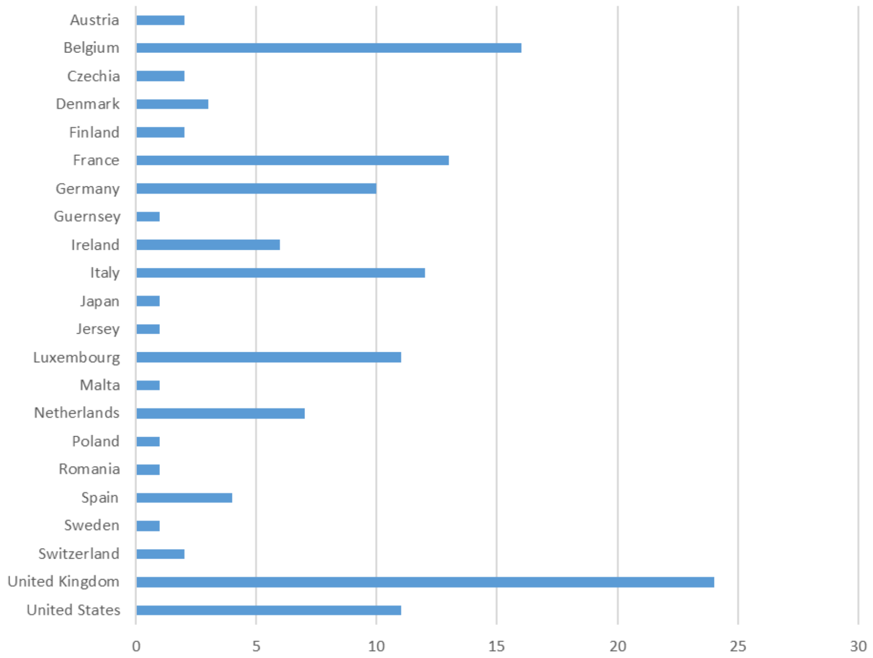


Chart 2 – Field of activity of private sector respondents



Charts 3 – Location of respondents



Responses to the consultation

II. Investor protection

32. What would be the potential benefits and risks associated with the introduction of the depositary passport? Please explain your position, presenting benefits and disadvantages of your suggested approach as well as potential costs of the change, where possible:

The vast majority of the respondents expressed their concerns whether the financial market would profit from the introduction of a depositary passport. Nevertheless, the responses have been varied across the respondents.

The arguments in favour of the introduction of a depositary passport have mentioned the following arguments. The introduction of the depositary passport would lead likely to promote a greater competition across the EU and, therefore, to lower costs and a decreased counterparty risk. Especially in smaller jurisdictions, the depositary passport would mitigate the market power of a few local depositaries while granting access to a higher number of depositaries. This enhances competition, increases the choice of services and leads to a more efficient market. Depositaries could offer their services simply in more Member States which reduces the costs, and would lead to economies of scale and operational efficiencies. As a result this could lead to lower costs for investors. Depositary pass porting can support creating centres of excellence by allowing depositaries to work from abroad and accumulating knowledge. The respondents have suggested the following pass porting procedure for depositaries. Depositaries shall inform the NCAs when intending to provide services on a cross-border basis and sets out the details of which services it plans to provide. It shall notify the details which AIF the services will be provided to and then the NCA of the home Member State notifies the NCA of the host Member State. Furthermore, the respondents hope that the introduction of the depositary passport reduces regulatory burdens among Member States and supports the harmonisation of regulatory conditions across the EU. Otherwise, the respondents do not expect the introduction of a depositary passport a success.

The respondents that have opposed the introduction of a depositary passport have made the following statements. Firstly, every Member States implemented an own regime on its supervisory agencies, which can lead to confusing when it is not clarified which regimes applies to a depositary which operates in a host Member State. Depositary functions are defined by the AIFMD Directive, however, the interpretations given by the NCAs vary profoundly among the Member States with the consequence that the procedures, the methodologies, the organisational systems and the human resources required to the depositaries to conduct their functions are very different. Secondly, in case the AIF and its depositary are not located in the same state, different laws may apply which can cause legal uncertainties. Having the depositary in a jurisdiction other than of the fund's domicile would additionally complicate the effective supervision by the fund's NCA, as well as the depositary's oversight over the fund and its management company. Thirdly, a future change of an AIF's depositary may lead to a change in the applicable material law. Therefore, a procedure needs to be set in place how other actors such as investors could be informed in this case. Fourthly, an AIF and its depositary located in two different states would entail that the supervision would be conducted by different NCAs and, therefore, creates challenges and risks unless the division of supervisory authority is not fully clarified. The passport is likely to create challenges for NCAs to supervise depositaries, which perform key oversight obligations in respect of the AIF. Fifthly, investors and the depositary itself bear the risk that the depositary does not sufficiently understands local regulations and oversight is less robust, when the depositary has not presence in the home country of the AIF. Sixthly, the enforcement of investor's right might be more complex or uncertain. Seventhly, smaller market participants could be forced to leave the market, which could lead to a systemic risk, when merely bigger depositaries remain. A few remaining depositaries would reduce competition which could cause higher costs and a concentration of depositaries. Furthermore, local knowledge and experience could be lost.

Having said that, it might be important to acknowledge that the responses varied widely across the field of activity of the respondents. Public authorities have nearly exclusively expressed their concerns about depositary pass-porting.

33. What barriers are precluding introducing the depositary passport? Please explain your position providing concrete examples and evidence, where available, of the existing impediments:

The vast majority of the respondents mentioned the lack of harmonisation across Member States the most important barrier, which is precluding the introduction of a depositary passport. In particular, national laws vary on securities and insolvency laws vary among Member States and can lead to confusion about the applicability in case of bankruptcy. Moreover, the depositary has to ensure the applicable national laws while carrying out sales, issues, re-purchases, redemptions and cancellations of units or shares of the investment fund, calculating the value of the units or shares of the investment fund, distributing or reinvesting an AIF's income, introducing the AIF to the depositary. As well as insolvency and securities legislation, regulatory frameworks in terms of custody regulations and investor protection lack effective harmonisation. The approval process and the requirements applied vary from Member State to Member State and are not harmonised at an EU level, which is why a few respondents suggested creating an EU-AIF similarly to the introduction of the Societas Europaea (SE). Due to a lack of harmonisation among Member States, AIFs are currently subject to significant local regulatory requirements outside of the AIFMD framework, which are set out by the Member States.

Furthermore, respondents have emphasised the lack of trust among NCAs in different Member States and the centralisation of the depositary industry in a few Member States. The respondents have expressed their concern that the introduction of a depositary passport could lead to new forum shopping practices, which would benefit states, which have introduced the best practices.

34. Are there other options that could address the lack of supply of depositary services in smaller markets? Please explain your position presenting benefits and disadvantages of your suggested approach as well as potential costs of the change:

The majority of the respondents emphasised that the possibility for depositaries to provide cross border services would address the lack of supply of depositaries in smaller markets at best. The obligation to appoint a depositary located in the same jurisdiction as the fund shall be replaced. Nevertheless, the respondents express the in question 32 and 33 mentioned concerns about the risks of allowing cross border services for depositaries by introducing a depositary passport. Some respondents suggested modernising the current banking and investment firm regime to simplify opening branches for MiFID firms by reducing the level of organisational requirements. It would entail more flexibility in the human, technical and infrastructure requirements for opening new branches. New branches would benefit anyhow from its headquarters predominantly located in bigger asset markets. Other respondents suggested a review of the current framework, which has been introduced after the financial crisis in 2008 and might be outdated which could discourage the industry from starting new operations in smaller markets. The respondents stressed in particular requirements concerning cash monitoring, safekeeping and oversight duties.

However, some respondents - predominantly public authorities from smaller markets – stressed that they were not aware smaller markets would suffer from a shortage of supply of depositaries.

III. International relations

50. Are the delegation rules sufficiently clear to prevent creation of letter-box entities in the EU? Please explain your answer to question 50:

The vast majority of the respondents considers the delegation rules sufficiently clear to prevent the creation of letter-box entities in the EU. Some respondents wish for a further clarification whether a business practice falls within the scope of management delegation, since significant differences in the interpretation by the Member States have occurred. The further clarification could be carried out by ESMA, providing guidance to enhance supervisory convergence and consistency. Nevertheless, intra-group delegation and advisory by external investment advisers plays a key role in the AIFM sector, which is why this business model shall be considered as delegation and shall not fall within the definition of letter-box entities.

Furthermore, a considerable number of respondents would prefer more convergence on letter-box rules between AIFM and UCITS. The UCITS framework provides general statements on the impossibility of delegating functions, whereas the AIFM framework is far more specific. In particular, public authorities stressed that the rules regarding delegating the performance of investment management should be clarified.

Some respondents consider the current framework robust enough to prevent the occurrence of letter-box entities and see, therefore, no necessity to amend or change the current provisions of the AIFMD.

51. Are the delegation rules under the AIFMD/AIFMR appropriate to ensure effective risk management? Please explain your answer to question 51, presenting benefits and disadvantages of the current rules and where available providing concrete examples substantiating your answer:

The vast majority of the respondents considers the AIFMD/AIFMR appropriate to ensure effective risk management. The respondents emphasise that effective risk management depends critically on the ability of the manager to control the delegated function. Whether the manager can control the delegated function depends on the type of delegation. There are three different types of delegation mentioned by the respondents. Firstly, the portfolio management functions are delegated partially, which enables the manager to control the activities of the delegate due to retaining sufficient expertise on the functions, which have been delegated. Secondly, the portfolio management functions are delegated fully within the EU and though to an intra-group entity. In this model, the delegate and the manager are subject to the same rules and are supervised by EU NCAs, which share a common regulatory framework. Thirdly, the portfolio management functions are completely delegated to an extra-group entity within or outside of the EU. In this scenario, the manager does not retain sufficient expertise on the portfolio which causes difficulties on supervising the delegate. Further problems occur, when different regulatory frameworks apply to the delegate and the manager which is the case when the manager is not located within the EU. The delegate does not fall within the scope of an EU NCAs. Which is why respondents suggested to strengthen the applicable rules on the delegation of risk management to third-country undertakings.

IV. Financial stability

In the public consultation, 91 respondents replied to the section on financial stability, which includes question on liquidity risk management and reporting. Notably, almost three fourths of these respondents (67) consisted of business associations, companies or business organisations (industry), and 10 were public authorities.

The full sample is split on the need to further enhance AIFMD framework to more effectively address macroprudential concerns (question 56), with 40 respondents expressing a positive opinion, 40 a negative one and 11 no opinion. Public authorities are broadly in favour (9/10), just like a significant minority of the industry (35 no, 23 yes, 9 no opinion). Among those supportive, most support is gathered for the options to harmonise LMTs (28/40 overall, 8/9 public authorities, 15/23 industry), to improve supervisory reporting requirements (22/40 overall, 7/9 public authorities, 9/23 industry) and to further detail cooperation of NCAs in case of activating LMTs (15/40 overall, 5/9 public authorities, 6/23 industry), in particular in situations with cross-border implications.

The full sample is also split on the need to report the activation of LMTs by AIFMS to NCAs, with 33 in favour, 33 against, and 18 expressing no opinion (question 59). Again, this is broadly supported by public authorities (9/10) and also by a significant minority of industry respondents (20 in favour, 28 against, 15 no opinion).

The questions on the appropriateness of the supervisory reporting requirements as provided in the AIFMD framework and potential improvements led to more mixed replies. 50 respondents agree that it is somewhat or fully appropriate, 17 somewhat or fully disagree that it is appropriate, 7 are neutral and 10 have no opinion. The mandatory introduction of a LEI to identify an AIF and an AIFM gathered broad support, also within the industry (questions 63 and 64). The same is true for giving relevant national and/or EU institutions with responsibilities in the area of financial stability access to the AIFMD supervisory reporting data (question 68). Improving the fund classification under the AIFMR supervisory reporting template (question 70) is supported by an overall majority in the full sample, including broad support among public authorities a majority of industry respondents.

On several other topics there is broad agreement among public authorities, whereas the industry has a different view. This concerns the need to provide a more comprehensive portfolio breakdown in AIFMD supervisory reporting (question 62), the inability of the AIFMR template to effectively capture links between financial institutions (question 69), the introduction of supervisory reporting for UCITS (question 76), the harmonisation of supervisory reporting requirements for UCITS and AIFs (question 77) and the harmonisation of leverage calculation metrics at EU level and leverage calculation methods for UCITS and AIFs (questions 80 and 82).

Only a minority in each category supports centralised data reporting (question 67).

66. Does the reporting data adequately cover activities of loan originating AIFs? Please explain your answer to question 66:

The majority of the respondents agrees that the current reporting data adequately covers activities of loan originating AIFs. The respondents emphasised that the current reporting framework provides regulators with sufficient access to the information they need in order to supervise loan originating AIFs activities effectively. Implementing new reporting requirements would increase operational burdens. Furthermore, loan originating AIFs neither present liquidity mismatches nor use a significant leverage. The market for loan originated AIFs is rather small. Some respondents recommended to distinguish between the several types of AIFs to gather more information about the growth and risks of loan originating AIFs. Some respondents expressed their concern that adding a further data field could add operational burdens and costs to loan originating

AIFs, which could have a negative impact on providing credit to European businesses by loan originating AIFs. It would change the structure of the aggregated and consolidated AIFMD reporting to an asset-by-asset reporting.

If not, what data fields should be added to the supervisory reporting template:

Only one respondent has answered this question by suggesting to add loans originated by AIFs and leveraged loans originated by AIFs to the supervisory reporting template.

Please explain why you think loans originated by AIFs should be added as a data fields to the supervisory reporting template, providing information on the benefits, disadvantages and costs of implementation:

The respondents have stated that private corporate lending has grown substantially over the last year which is why the sector is lacking transparency and data provided for supervisory purposes. Therefore, AIFM should provide NCAs and ESMA with a description of the type of financing and its key features in order to assess whether these market practices could create a systemic risk. Public authorities have emphasised that they are currently experiencing a lack of data and, therefore, would welcome adding these data fields. Reporting requirements for leveraged loans could be developed by the Commission.

Please explain why you think leveraged loans originated by AIFs should be added as a data fields to the supervisory reporting template, providing information on the benefits, disadvantages and costs of implementation:

The respondents stressed that adding leveraged loans originated by AIFs as a data field to the supervisory reporting template would enable NCAs and ESMA to monitor the market and possible occurring risks. Extending the supervisory reporting template would give a clearer overview over different investment strategies. Some NCAs collect already data about AIFs which either hold loans as part of their assets or originate loans. Currently, the reporting template often does not distinguish between these two different AIFs.

Please explain what other data field(s) should be added to the supervisory reporting template, providing information on the benefits, disadvantages and costs of implementation:

The respondents suggested that a data field concerning debts and the type of debt could be added. Moreover, the reporting requirements shall apply to larger loan originating funds where stability can be an issue.

85. Should the requirements for loan originating AIFs be harmonised at EU level? Please explain your answer to question 85:

A narrow majority of the respondents does not think that requirements for loan originating AIFs should be harmonised at EU level. The respondents emphasised that AIFMs managing loan-originating funds are already subject to the authorisation, due diligence, risk management, liquidity and transparency requirements that generally apply to AIFMs. They are as well subject to the supervision of EU authorities and NCAs. Furthermore, loan-originating funds are usually closed-ended funds, with a low level of leverage and represent, therefore, low levels of risk credit transformation. Merely professional investors invest in these funds and understand the associated credit and liquidity risks. A few respondents recommended to collect further data to assess whether loan originating funds cause a systematic risk.

Since there are very diverse types of AIFs managed by AIFMs on the market, no other AIFs asset class has been made subject to specific regimes under the AIFMD framework. It is stated in recital 10 of the AIFMD explicitly, that the Directive does not regulate AIFs and that 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". Some respondents suggested to wait implementing additional requirements for AIFs until the ELTIF review and any necessary reforms are implemented.

If yes, which of the following options would support this harmonisation

The respondents recommended to impose leverage limits, additional organisational requirements for AIFMs, diversification requirements and concentration requirements; to allow only closed-ended AIFs to originate loans; to provide for certain safeguards to borrowers; and to permit marketing only to professional investors.

Please explain why you think limiting interconnectedness with other financial intermediaries would support this harmonisation. Please provide information, where available, on the costs and benefits, advantages and disadvantages of this option. Concrete examples are welcome:

Only one public authority has replied to this question and emphasised that harmonising requirements for loan originating AIFs would allow more effective monitoring of credit intermediation activities by AIFs. Therefore, the Commission should develop consistent definitions and regular reporting requirements for leveraged loans, including the identification of covenant-lite leveraged loans, to facilitate the regular monitoring of risks and vulnerabilities in the sector.

Please explain why you think imposing leverage limits would support this harmonisation. Please provide information, where available, on the costs and benefits, advantages and disadvantages of this option. Concrete examples are welcome:

The respondents made the following recommendations. One respondent welcomes a greater harmonisation of loan originating AIFs on EU level to create a level playing field between jurisdictions. Nevertheless, the respondents argued in favour to not impose leverage limits to AIFs reserved for professional investors. Another respondent recommend to set up loan originating funds merely as closed-ended vehicles reserved for professional investors, without the right of redemption of units on a regular basis.

Public authorities suggested imposing a definition of appropriate safeguards to avoid excessive liquidity and maturity transformation or limit cash borrowing to 30% of the net asset value. Furthermore, they recommend the implementation of the following requirements, such as: prohibition to originate loans with open-ended funds; (requirement for loans to be eligible to have shorter maturities than the life of the fund; limitation of cash borrowing to 30 % of net asset value; limited use of derivatives; requirement on the asset management company to gather sufficient expertise and develop robust valuation methodology as well as specific risk management framework to ensure sound credit origination.

Please explain why you think imposing additional organisational requirements for AIFMs would support this harmonisation. Please provide information, where available, on the costs and benefits, advantages and disadvantages of this option. Concrete examples are welcome:

Predominantly public authorities answered this question. They suggested that loan originating funds shall demonstrate that they have the expertise required to select loans and have set up processes for loan processing, loan processing control, intensified loan management, the processing of problem loans and risk provisioning. They should be required to develop a system for analysing and measuring credit risks as well up-to-date knowledge of borrowers and credit risk selection procedures. These procedures shall enhance the early detection of risks and to identify in good time borrowers whose exposures are starting to show signs of heightened risk.

Please explain why you think allowing only closed-ended AIFs to originate loans would support this harmonisation. Please provide information, where available, on the costs and benefits, advantages and disadvantages of this option. Concrete examples are welcome:

The respondents, which are primarily public authorities, mentioned that loans are inherently illiquid assets and can create risks arising from maturity mismatches. Therefore, the nature of loan originating AIFs is illiquid which does not suit open-ended AIFs. Excessive liquidity transformations of open-ended funds shall be avoided.

Please explain why you think providing for certain safeguards to borrowers would support this harmonisation. Please provide information, where available, on the costs and benefits, advantages and disadvantages of this option. Concrete examples are welcome:

[The answers to this question have exactly the same wording given to the questions above by the same organisations and authorities]

Please explain why you think permitting marketing only to professional investors would support this harmonisation. Please provide information, where available, on the costs and benefits, advantages and disadvantages of this option. Concrete examples are welcome:

The responses to this question varied among the respondents, which were provided mostly by public authorities. One respondent suggested that allowing marketing, on a cross-border basis, to retail investors shall be subject to extremely precise requirements and robust safeguards for investor protection. Another respondent emphasised that private investors can hardly assess the risks arising from loan originating funds, but the investor must be enabled to assess these risks.

Contrarily, a respondent does not see any reasons why loan originating funds cannot do marketing towards retail investors, when being authorised according to Art. 43 AIFMD.

Please explain why you think imposing diversification requirements would support this harmonisation. Please provide information, where available, on the costs and benefits, advantages and disadvantages of this option. Concrete examples are welcome:

The respondents state that concentration and diversification limits applicable to loan originating AIFs shall be harmonised. Currently, significant differences in national risk and investment concentration and diversification regimes lead to market distortions, with operators enjoying competitive advantages in raising capital and flexibility in the management policies of their AIFs.

Please explain why you think imposing concentration requirements would support this harmonisation. Please provide information, where available, on the costs and benefits, advantages and disadvantages of this option. Concrete examples are welcome:

Merely public authorities have replied and suggested that loan originating AIFs shall include requirements on diversification and concentration in the investment policy and ensure that investors are informed. Therefore, the loan granted to each borrower shall not exceed 20% of the aggregate invested fund's capital.

Please explain what other option would support this harmonisation. Please provide information, where available, on the costs and benefits, advantages and disadvantages of this option. Concrete examples are welcome:

The respondents have suggested the following options, which would support the harmonisation. One respondent suggested introducing liquidity requirements, one redemption option per month, a notice period for redemption of at least one month, and clear communication about the application of redemption gates. Other respondents mentioned to include private loans in the AIFMD regime to enable AIFs to perform a role of alternative credit provider by offering financing to SMEs and smaller size deals. Another respondent recommended enhancing participation of a broad range of counterparties to central clearing which could reduce concentration risks and enhance the portability of client positions.

Table 2 below shows support by the public authorities for the different ideas concerning the LOFs as raised in the public consultation:

Table 2 Public authorities supporting different elements of possible regulation

Propositions	Member State support
1. Harmonising EU level requirements for AIFMs managing LOF	7
2. Impose leverage limits	2
3. Impose additional organisational requirements for AIFMs	2
4. Allow only closed-ended AIFs to originate loans	3
5. Permit marketing only to professional investors	2
6. Impose concentration requirements	3
7. Provide for certain safeguards to borrowers	1
8. Impose diversification requirements	2

9. Require for the loans to have shorter maturities than the life of the fund	1
10. Limit cash borrowing to 30 % of net asset value	1
11. Limit use of derivatives	1
12. Limit interconnectedness with other financial intermediaries	1
13. Restrict consumer lending by LOFs	1
14. Against harmonisation of detailed requirements for LOFs	1
15. No opinion	2

ANNEX 3: WHO IS AFFECTED AND HOW?

Practical implications of the initiative

<u>Fund managers:</u> AIFMs may be able to undertake loan origination across the Union including Member States where they are currently prohibited from lending. A new framework would also harmonise requirements across Member States reducing compliance and reporting costs for managers. Access to the broader market may allow funds to scale up quicker.

Fund managers in the smaller markets may get access to cross-border supply of depositary services allowing a wider choice among service providers and potentially leading to lowers cost of service as well as to access of bundled services thus generating better returns for investors.

Fund managers are likely to benefit from the clearer delegation rules providing more legal certainly around the substance requirements. This is going to augment compliance costs only for the letterbox entities, which are outlawed by the current rules anyways, but not for a properly functioning fund managers.

<u>Investors:</u> Investors will be able to access a wider range of larger funds engaged in loan origination. Market data indicates a clear preference among investors for this asset class particularly given the current low interest rate environment. Implementing a framework for AIFMs of LOFs will improve the resilience and transparency of these funds ensuring appropriate levels of investor protection while also possibly reducing funds costs due to increasing economies of scale as the funds grow in size.

Investors of AIFs established in smaller markets would benefits from the cross-border accessibility of the depositary services as this is likely to bring down the cost of depositary services and improve their quality. A better access to such services may benefit development of the AIF market in smaller jurisdictions leading to a wider choice of investment opportunities.

Investors are likely to be better protected where the EU rules on delegation requirement are clarified to ensure that AIF and UCITS managers ensure they have the necessary human recourses to supervise the entities to which portfolio or risk management or other functions are delegated. This would also ensure the same level of their protection across the Union.

National Competent Authorities (NCAs): NCAs would be enforcing a common supervisory framework improving supervisory cooperation and transparency in their jurisdictions. Additional reporting, disclosure and stress testing requirements would reduce the potential risks posed by loan originating funds.

NCAs in the smaller jurisdiction would have a discretion to allow cross-border sourcing of the services.

NCA will have a clearer rulebook to enforce once the rules on delegation are clarified. This should reduce regulatory arbitrage ensuring the same supervisory standards across the Union.

ESMA: A European framework for AIFMs managing LOFs would increase supervisory convergence across the Union and provide additional reporting data to ESMA.

ESMA will also receive additional reporting information in relation to delegation arrangement that it will need to store and process in order to distil the market trends in this respect.

SMEs: Loan originating funds can provide an additional lending channel to provide funding to the real economy and particularly SMEs that may find it difficult or costly to borrow from traditional lenders. Increased competition and scale may also reduce borrowing costs further and support the economic recovery from the pandemic. The shock absorbing capacity provided by LOFs may also help funds obtain credit during times of market stress or liquidity shortages.

Summary of costs and benefits

I. Overview of Benefits (total for all provisions) – Preferred Option		
Description	*Amount*	*Comments*
	Direct benefits	
Increased availability of capital finance for SMEs across the Union.	No estimate available.	Funds will be able to provide loan origination services across the Union providing additional sources of finance for the real economy and SMEs, particularly those that may not be able to access traditional lending.
Loan originating funds can act as a shock absorber at times of	No estimate available.	LOFs can continue to lend during times of market stress and liquidity shortages supporting the real

market stress		economy when traditional lenders may be unable to do so. More stringent requirements around lending and portfolio management will mitigate risks that LOFs could pose to broader systemic stability.
AIFMs in smaller markets able to source depositary services across the border	Reducing costs for the depositaries: no need to take out another licence (a new depository licence costs between € 6,000 – € 9,200 depending on a Member State) and saving on annual supervisory fees (between € 4,400 – € 9,400 depending on a Member State). No estimate available as to the fees that could be saved by the AIFM.	The benefits for the depositaries are tangible in terms of cost savings. The AIFMs will benefit from a wider choice of service providers and more effective service provision (accessing packaged services). More competition is likely to bring the depositary services down in the Member States, which will permit sourcing depositary services
Clarifying delegation requirements and ESMA collecting information on a full delegation of investment or risk management to the third country entities.	No estimate available.	Investors would be better protected by the Union rules more clearly imposing minimum substance requirements for AIFMs and UCITS managers delegating their functions to third parties Legal certainty and level playing field for AIF and UCITS managers when they delegate functions to third parties. Policy makers will be better equipped to take future decisions in relation to delegation regime by having a more information on the practical use of delegation by t fund

		managers.
Harmonising the availability of LMTs across the Union and requiring the managers of open-ended funds chose at least one LMT that could be activated in times of stress.	Cost indication for changing contractual and pre-contractual documents, prospectuses in particular, could be up to € 40 000 per product/service. However, because of regulatory changes or other reasons, these documents are normally revised at least every year anyway.	Managers will be better equipped to deal with liquidity pressures in times of stress. Investor interests will be better protected by preserving investment value in times of stress.
More granular reporting of data on AIFs and UCITS.	No cost impact before the next step.	In line with the supervisory data strategy preparing the ground for supervisor access of more granular data for market monitoring.
	Indirect benefits	
Loan originating funds able to scale-up and market cross-border	No estimate available.	The ability of loan originating funds to scale up and operate on a cross border basis will increase the availability of finance for SMEs and other commercial entities in Europe particularly in MS where this activity is not currently authorised.
AIFMs in smaller markets able to source depositary services across the border	No estimate available.	Better access and more competitive pricing of depositary services may facilitate growth of the smaller investment fund markets.
CSDs subject to the AIFMD and UCITSD rules when they hold in custody funds' assets, whereas ex-ante due diligence requirements for the depositary are waved	No estimate available.	Investor would be better protected as with the information flow from the CSDs to the depositaries the latter will be able to carry out their oversight duties properly.

(1) Estimates are relative to the baseline for the preferred option as a whole (i.e. the impact of individual actions/obligations of the preferred option are aggregated together); (2) Please indicate which

stakeholder group is the main recipient of the benefit in the comment section;(3) For reductions in regulatory costs, please describe details as to how the saving arises (e.g. reductions in compliance costs, administrative costs, regulatory charges, enforcement costs, etc.; see section 6 of the attached guidance).

II. Overview of costs – Preferred option							
		Investors		Fund Managers		Supervisory Authorities	
		One-off	Recurrent	One-off	Recurrent	One-off	Recurrent
AIFMs managing LOF	Direct costs	No cost impact	No cost impact	No cost impact	Increased compliance costs due to additional requirements for loan origination, reporting and disclosure	No cost impact	May incur additional costs related to additional reporting requirements.
	Indirect costs	No cost impact	No cost impact	No cost impact	May allow funds to scale up faster and provide loan origination across the Union. Increased availability of sources of finance for SMEs	No cost impact	No cost impact
Facilitating cross-border sourcing of depositary	Direct costs	No cost impact	No cost impact	No cost impact	Reduced cost of accessing depositary services	No cost impact	May incur additional supervisory costs related to cross border

services							provision of services
	Indirect costs	No cost impact	No cost impact	No cost impact	May allow funds to scale up faster and provide loan origination across the Union. Increased availability of sources of finance for SMEs	No cost impact	No cost impact
Harmonising availability of LMTs	Direct costs	No cost impact	No cost impact	No cost impact	Reduced cost of accessing depositary services	No cost impact	No cost impact
	Indirect costs	No cost impact	No cost impact	No cost impact	No cost impact	No cost impact	No cost impact
More granular reporting	Direct costs	No cost impact	No cost impact	No cost impact	May lead to a slight increase in administration costs to provide more detailed reporting	No cost impact	May incur additional costs to receive and process additional reporting data
	Indirect costs	No cost impact	No cost impact	No cost impact	No cost impact	No cost impact	No cost impact
Delegation	Direct costs	No cost impact	No cost impact	No cost impact	Some fund managers may have to adjust their organisational structure or	No cost impact	No cost impact

					delegation arrangements to comply		
	Indirect costs	No cost impact	Some funds may increase fees due to costs from additional substance reqs	No cost impact	No cost impact	No cost impact	No cost impact

(1) Estimates to be provided with respect to the baseline; (2) costs are provided for each identifiable action/obligation of the preferred option otherwise for all retained options when no preferred option is specified; (3) If relevant and available, please present information on costs according to the standard typology of costs (compliance costs, regulatory charges, hassle costs, administrative costs, enforcement costs, indirect costs; see section 6 of the attached guidance).

Cost quantification:
While stakeholder feedback to the public consultation did not contain specific comments related to costs, the KPMG report indicated potential cost issues for smaller managers and funds which could limit the number of small private equity or venture capital funds operating in the Union. KPMG also highlighted additional costs for non-EU AIFMs that could act as a barrier to entry to the EU market. AIFMs have experienced a general increase in costs with nearly 88% of respondents claiming that their supervisory reporting costs had increased with a number highlighting overlapping reporting requirements as a cost driver. Respondents also called for efforts to address the overlaps and reduce the introduction of further piecemeal or high cost reporting requirements.

With regard to the AIFMD, the proposed policy and technical options are designed to improve the functioning of the framework from a manager and supervisory perspective and where possible reduce costs or ensure that the benefits of the chosen option outweigh the additional costs:

a) The harmonisation of available LMTs may lead to additional costs for some managers due to the need to update their legal documentation but at the same time will lead to direct benefits by improving the resilience of these funds by allowing managers additional flexibility to manage their liquidity risks while maintaining the general level of investor protection.

b) Facilitating cross-border sourcing of depositary services will reduce costs for fund managers in Member States that are underserviced in this space and reduce concentration risks of having only a single or limited number of depositaries available in a Member State.

c) Fund managers are already required to report to supervisory authorities, there may be some costs associated with more granularity but the additional burden should be minor and is outweighed by the supervisory benefits of greater transparency regarding funds activity. At the same time the proposed changes may introduce additional efficiencies for fund managers by eliminating reporting overlaps.

d) With respect to AIFMs managing loan-originating funds, the proposed requirements will protect financial stability and introduce more effective credit management processes while allowing these funds to operate on a cross border basis and harmonising their regulatory requirements, which will introduce new cost efficiencies and allow them to scale up their funds.

e) The clarifications of delegation requirements may impose additional staffing costs on certain funds but these are outweighed by the additional protections these clarifications will give to investors and the stability of the broader financial system and general improvements to supervisory effectiveness and convergence.

ANNEX 4: ANALYTICAL METHODS

Overview:

The analysis underlying the impact assessment is based on three methodological approaches: 1. desk research; 2. qualitative analysis; and 3. quantitative analysis.

The data used stems from several different data sources. Input was collected from a wide range of stakeholders, including asset managers, industry and trade associations that represent investors, academics and citizens. Stakeholder feedback was gather through an open public consultation on the functioning of the AIFMD, bilateral consultations with the stakeholders, policy dialogues with the NCAs and ESMA (including previous technical advice received ESMA and its letter of August 2020 which made a number of recommendations for the review.

Industry research papers on LMTs, delegation and loan originating funds were also provided by stakeholders.

A report on the functioning of the AIFMD was also prepared by KPGM. In accordance with the Alternative Investment Fund Managers Directive (AIFMD), on 10 June 2020 the Commission provided the European Parliament and the Council with a report assessing the effectiveness of the AIFMD. The report concludes that the AIFMD has had a largely positive impact and generally works well.

1. Desk research:
A literature review was performed regarding the functioning of the AIFMD and its impact on the market for AIFs. Relevant (academic) literature was also consulted to gain additional insight into market developments such as the growth and structure of the loan origination sector, the use of LMTs, the use of delegation by fund managers and the need for better reporting data.

2. Qualitative analysis:
This review implemented a three-fold methodological approach to the consultation with stakeholders - (i) public stakeholder consultation and (ii) gathering additional feedback and material through bilateral follow-up interviews with fund managers, representative organisations, Member States and supervisory authorities.

   The public stakeholder consultation was conducted prior to the impact assessment. The consultation was open so the design would ensure a diverse representation of different stakeholders to gather as wide a range of views on the AIFMD as possible. The public consultation provided insight on the priority areas for stakeholders and allowed the identification of key themes and issues. Details on the public consultation can be retrieved in Annex 2.

   The follow-up bilateral consultations allowed stakeholders to further explain their submissions to the consultation and highlight areas of specific concern. These consultations also allowed the Commission to query and clarify the submissions and ensure they were accurately reflected in this impact assessment.

3. Quantitative analysis:
Market data was gathered from industry research and ESMA databases on the size and make-up of Europe's AIF market and specific fund classes such as loan originating funds. Analysis of this data was used to develop the various policy options in this impact assessment.

4. Limitations:
Market data:
Certain limitations were encountered with the quantitative data, in particular the inability to identify precisely the size of the loan originating funds sector due to the lack of granularity in the reporting data. However, alternative industry research was used to address this limitation in the regulatory data.

Granular cost data and itemisation: Detailed information on fund manager or fund costs (including regulatory fees, compliance costs, search costs, operational costs, marketing costs, etc.) is not available at a detailed level. Regulatory fees are available at this level of detail, but they only constitute a small part of total costs.

Overall, significant efforts have been undertaken to support the analysis of the operation of the AIFMD and the evaluation of policy options. As the combined evidence stemming from the various methodological approaches provide corroborating evidence, it can be considered to be a sound basis for the impact assessment despite the identified data limitations.

ANNEX 5: RISKS OF LOAN-ORIGINATING FUNDS

I. *Risks emanating from the activities of the loan-originating AIFs*

According to the CBI[81], the origination of loans by funds has specific features that can present particular fund level financial and legal risks, in particular:

a) *Concentration Risk*

Direct lending portfolios may build up concentrations due to exposure to a certain sector or collection of borrowers with similar economic characteristics, it takes time to build a loan book which may mean that it is dominated by a small number of initial positions at the beginning and/or loan books may only contain a few loans. This concentration can also result from the sectoral expertise or focus of the loan team and the natural evolution of the loan book.

b) *Illiquidity Risk*

Private lending is intrinsically illiquid. Whereas secondary markets may facilitate the trading in certain types of standardized loans, this may not be the case for private loans. This makes it particularly important that investors understand the quality of the performance of the portfolio, particularly where cash flows are only remitted to investors a number of years after the funds launch. It is also important that the structure of the investment vehicle does not permit redemptions that could force fire sales of loan assets that could adversely affect the funds investors.

c) *Risk of investor runs*

There is a risk that funds may be structured in a way that creates a mismatch between their liquidity and/or maturity of their assets and liabilities. This can create a credit channel that is prone to swings in investor confidence and may lead to pro-cyclicality of credit supply. A run could also have broader systemic consequences if the fund holds a concentrated position in a particular segment of the market.

d) *Leverage*

Where funds employ leverage to increase portfolio returns they are introducing additional risks. Leverage can lead to encumbrance of the loan portfolio and

[81] Loan Origination by Investment Funds, Discussion Paper, Central Bank of Ireland July 2013.

reduce the claim of investors on the fund in the event of liquidation or bankruptcy. Leverage may confer on the lenders to the fund, rights or covenants that allow them to direct the operation of the fund, including the sale of assets, in certain instances.

e) *Dominant Lenders*

Certain originators may become dominant lenders to specific sectors of the real economy. There is a risk that these lenders may set less stringent pricing or loan documentation terms which could deter other entrants while also creating an unsustainable lending channel.

f) *Misalignment with investor risk profiles or suitability*

Loan funds will typically hold assets that are not traded on secondary markets and are illiquid, not be open to regular redemption requests, invest in sectors not closely or intensively analysed by investment advisors and not pay cash flows on a regular basis during the early life of the fund. There is a risk of significant information asymmetry with investors forced to hold the investment for long periods of time.

g) *Mispricing of credit*

There is a risk of mispricing due to a lack of incentive alignment. This risk can arise as the loan issuance and pricing decision will be driven, to a large degree, by either an investment manager or in some cases by an external specialist, both of whom receive a transactional fee that may not be affected by the performance of the loans. In addition, excess investor demand may lead to a decline in the quality of the loan origination process due to the challenges of meeting those demands. As a result, loan documentation may be weaker, the nature of the borrowers riskier of the collateral provided poorer.

Systemic Risk

According to the ESRB, certain key criteria can help identify the systemic importance of loan originating funds including substitutability, size and interconnectedness:

a) *Substitutability*

Loan-originating funds are part of the alternative finance system. Unlike the failure of a traditional bank or Money Market Fund, the bankruptcy of a loan-originating fund should not lead to a liquidity crisis in financing the real economy as there would be other European credit institutions available to step in to the market.

However, this situation poses risks of regulatory arbitrage and uneven playing field with other segments of the financial sector, in particular the banking sector. The emergence of an uneven playing field may be due to a wide range of factors, including lower funding and operating costs than banks or light credit risk management practices.

b) *Size*

Size alone does not create systemic risk.

c) Interconnectedness

The failure of large loan-originating fund would only pose a systemic risk to the extent that it is interconnected with other components of the financial system and in particular, credit institutions or fiduciary investors.

Contagion in the financial system could be through direct and indirect risk channels. In the case of prudential consolidation when a fund management company, which is a part of a group, makes losses this reduces the capital of the entire group and this is called a direct channel of contagion. Where there is no prudential consolidation a fund management company typically reduces dividends paid out to the parent company and the shareholder value of the fund management company diminishes.

Contingent liabilities and commitments create an indirect channels of contagion through non-contractual obligations. Whilst indirect channels should limit the impact for fund management companies because any losses suffered by a fund would be borne by the fund's investors. However, the 2008 financial crisis is a case in point where contagion to the financial system spread through direct and indirect channels. Parent companies in financial groups provided implicit guarantees to absorb various risks of fund investors. Consequently risk that normally is borne by fund investors was transferred to the balance sheet of a parent company – the bank. Moreover, direct support was provided in three distinct forms: foregoing fees (to enhance the return to the fund investors); liquidity support (sponsoring companies provided liquidity support to funds managed by other companies in the same financial group, when those funds suffered net redemptions or margin calls); capital support (during the crisis sponsors took on losses from the funds by or guaranteeing the value of the fund's assets).

Further links exist if the sponsoring banks provide contingent liquidity lines, financial guarantees and other contractual commitments to investment funds such as through derivatives markets and securities financing transactions. These "step-in" risks, associated with the interconnectedness between these asset management entities and their sponsors (often banks) are also the focus of the Basel Committee for Banking Supervision (BCBS).

d) Risk of runs in investment funds

In the case of insufficient safeguards, mismatches between the maturity of funds' assets and liabilities can make loan originating investment funds vulnerable to runs, particularly in the presence of uncertainties and the quality of these funds' assets. Runs could lead to asset fire sales, which, in times of stress, could spur contagion to other sectors.

e) Risks of excessive credit growth and pro-cyclicality

As the industry becomes larger, it could contribute to the self-reinforcing macro-financial mechanisms that arise from excessive risk taking and credit growth during upturns. However, macro-prudential authorities may lack effective instruments to mitigate such risks, as their scope of intervention may be focusing on the banking sector (e.g., through the counter-cyclical buffer). This asymmetry could further exacerbate regulatory arbitrage and the un-level playing field across the financial system.

The ESRB further noted that it is essential that authorities have adequate tools to monitor and address systemic risks associated with excessive credit growth and leverage across the entire financial system, including in loan originating investment funds. Authorities must have macro-prudential instruments capable of impacting directly the cost and the availability of credit over the cycle, including by limiting the use of leverage by funds and by tightening the lending standards of investment funds. Such instruments should be complementary to those available in the banking sector (e.g. countercyclical capital buffer), enabling authorities to take effective and consistent measures across different parts of the financial system.

In terms of establishing a European framework, a key recommendation from the 2016 ESMA study was the requirement for some form of authorization that would:

1. Allow NCAs to assess the credit origination capability of the investment manager;
2. Ensure that a framework exists from the date of inception of the loan-originating fund for the monitoring of the fund's contribution to systemic risk;
3. Ensure that the interests of borrowers are protected; and
4. Ensure that the interests of investors are protected (and that the regulatory requirements are tailored to investor types as appropriate).

In addition, ESMA recommended that any framework should ensure that the NCAs have all necessary powers to monitor, supervise and enforce the requirements set for managers and their funds.

Other issues considered by ESMA included:

1. Loan origination funds should be setup as closed ended funds but with a degree of flexibility to allow repayments to investors during the life of the AIF at fixed intervals;
2. Funds should not be allowed to have liabilities with shorter maturities than the loans granted by the fund;
3. Whether the fund should be allowed to carry out other investment activities than loan origination;
4. Whether the funds should be available to retail investors;
5. Additional organizational requirements to limit the risk profile of the funds including (i) policies and procedures governing risk management, (ii) the assessment, pricing and granting of credit, (iii) credit monitoring, renewal and refinancing, (iv) collateral management policy, (v) concentration risk management, (vi) operational risk control appropriate to loan origination, (vii) assessment and scoring of borrowers, (viii) valuation including collateral valuation and impairment, (ix) management of forebearance and identification of problem debt and (x) staff capability and expertise in loan origination;
6. Leverage limits. For example, Ireland imposes a limit of 200% of NAV while Italy imposes limits of 130% to 150% depending on the investor type;

7. Diversification limits to spread risk and avoid concentration buildup; and,
8. Prohibiting funds from extending loans to (i) individuals, (ii) financial institutions (iii) collective investment schemes and (iv) the AIFM and related parties. Funds should also not be permitted to engage in short selling, trading of derivatives other than for hedging or securities lending.

In its letter of August 2020, ESMA again called for the establishment of a framework for loan originating funds based on its 2016 study. ESMA also reference the possible role of these funds in the Covid-19 recovery while taking into account the specificities of their structures and activity.

ANNEX 6: TECHNICAL IMPROVEMENTS TO THE AIFMD THAT ARE NOT IMPACT ASSESSED

This Annex presents potential legislative improvements that do not entail comparing policy options. ESMA, the ESRB, and stakeholders recommend these legislative improvements to address financial stability concerns (liquidity management tools and inadequacy of supervisory reporting) or to address investors' protection issues due to inefficient regulation (level playing field for custodians of AIFs and UCITs assets). Part A of this Annex discusses these legislative improvements with technical choices and Part B of this Annex mentions legislative improvements without technical choices and, which basically clarify the current rules drawing on the discussions of the NCAs in ESMA as well as on the interpretations of the Union law by the Commission's legal service.

Part A: Potential legislating improvements with technical choices

This part of the Annex explores technical execution of the chosen policies to address three problems listed in section 1.2 of this impact assessment: (1) liquidity management by open-ended investment funds; (2) inadequate data reporting for market monitoring and (3) unequal treatment of custodians of AIFs' assets.

In the public consultation, 91 respondents replied to the section on financial stability, which includes questions on *liquidity risk management* and on *reporting*. Notably, almost three fourths of these respondents (67) consisted of business associations, companies or business organisations (industry), and 10 were public authorities.

The full sample was split on the need to further enhance the AIFMD framework to more effectively address macro-prudential concerns (question 56), with 40 respondents expressing a positive opinion, 40 a negative one and 11 no opinion. Public authorities were broadly in favour (9/10), just like a significant minority of the industry (35 no, 23 yes, 9 no opinion). Among those supportive, most support was gathered for the options to harmonise Liquidity Management Tools (LMTs) (28/40 overall, 8/9 public authorities, 15/23 industry), to improve supervisory reporting requirements for monitoring of financial stability risks (22/40 overall, 7/9 public authorities, 9/23 industry) and to further detail cooperation of NCAs in case of activating LMTs (15/40 overall, 5/9 public authorities, 6/23 industry), in particular in situations with cross-border implications.

1.1 Options to improve the availability of LMTs for open-ended AIFs and UCITS across the EU

The Options discussed in this section are relevant for considering changes to the AIFMD and UCITS frameworks.

Options 1 and 2 are mutually exclusive. The legislative improvements have been chosen following the ERSB Recommendations issued in 2017 to address liquidity risk in investment funds and supported by ESMA, as well as by the majority of national supervisory authorities. The ESMA report[82] issued in November 2020 following the

[82] ESMA34-39-1119

COVID crisis further reiterates ESMA support for the ESRB Recommendations on liquidity risk in investment funds. In fact, ESMA report identifies the increase of the availability and use of liquidity management tools as a priority area to enhance the preparedness of the funds to potential future adverse shocks that could lead to a deterioration in financial market liquidity. Additionally, feedback from representative bodies of the industry, given in bilateral discussions, confirmed that also these bodies support a harmonisation of LMTs' availability. Whereas enhancing ESMA's powers in facilitating and coordinating NCA actions when LMTs are activated with cross-border implications was not the option selected frequently in the public consultation, this might primarily reflect respondents' own perspective. It is however desirable from the European perspective. Moreover, proposed ESMA's powers are not binding, so not overly intrusive for national authorities.

Option	Description
Option 1: Harmonise the availability of LMTs for the managers of open-ended investment funds to choose from.	a) Harmonise the availability of liquidity management tools (LMTs) for open-ended investment funds (UCITS and AIFs) b) Require fund managers to choose at least one other appropriate LMT to include in the fund's constitutional documents in addition to suspension of redemptions c) Empower NCAs to activate gates as well as the LMT obligatorily chosen by fund managers d) Enhance ESMA's powers in facilitating and coordinating NCA actions when LMTs are activated with cross-border implications
Option 2: Harmonise the availability of LMTs for open-ended investment funds making a minimum set of LMTs obligatory and providing for an equivalent range of LMTs for NCAs to activate.	a) Harmonise the range and availability of LMTs to choose from by managers of open-ended funds b) Require managers of open-ended funds to include a minimum set of several, predetermined LMTs in the funds' constitutional documents c) Empower NCAs to activate in public interest any type of LMT (from among those LMTs included in the minimum set/funds' legal documents) d) Enhance ESMA's powers in facilitating and coordinating NCA actions when LMTs are activated with cross-border implications.

Option 1 proposes Union measures to address the potential risks that may be generated by open-ended funds experiencing liquidity problems under stressed market conditions. As recommended by the ESRB and concurred by ESMA, a wide set of liquidity management tools, which fund managers could choose from to include in the constitutional documents of their investment funds, could be harmonised and defined at the EU level. Also among respondents to the public consultation that favour enhancing the framework, the option to harmonise LMTs is the one suggested most (28/40 overall, 8/9 public authorities, 15/23 industry). Activating some LMTs, instead of selling assets to fully satisfy redemption requests, is a way to protect the value of investment and can thus be in the interests of investors. Some of the LMTs, such as swing pricing, particularly contribute to mitigating liquidity risks by reducing first-mover advantages. This may also contribute to financial stability by reducing risks under stressed market situations. Therefore, this Option suggests to make it obligatory for the fund managers of open-ended funds (both AIFs and UCITs) to, in addition to being able to suspend fund subscriptions/redemptions, choose from a common set of LMTs at least one other appropriate tool to include in their fund documentation.[83]

It is also recognised that the fund manager's decision to use a certain LMT may be influenced by reputational cost and competitive pressure, which imply that managers have an incentive to avoid deploying an available LMT. Additionally, they may not internalise potential externalities associated with asset sales in response to large-scale redemptions on the stability of the financial system. Therefore, when it is necessary to preserve financial stability, the NCAs should be able to intervene in the market and activate an appropriate LMT for the vulnerable funds. Currently the AIFMD empowers NCAs to suspend redemptions. Some NCAs are also granted the power to activate redemption gates based on national laws.[84] Redemption gates are a softer/more nuanced LMT than suspensions of redemptions, as they allow investors to still redeem a part of their AIF shares and thus limit the extent to which liquidity shocks are spread across the financial system. It thus seems sensible to grant all NCAs in the Union the power to activate also this LMT, that is the redemption gate, as well as the LMT (obligatorily) chosen by the fund manager and included in the fund documentation. NCAs would be expected to use the LMT on behalf of the managers in public interest to overcome their (in)action bias due to reputational/competitive reasons.

Moreover, since investment funds often invest and operate on a cross-border basis, the potential impact of liquidity problems is not limited to the jurisdictions in which the respective fund is domiciled. Liquidity tensions in an investment fund or a group of funds could thus "spill" to underlying asset markets and/or investors across borders. These potential cross-border effects accentuate the need for enhanced coordinating role for ESMA, which has been called for to coordinate supervisory responses during the Covid-19 pandemic. For the coordination to be more effective, it is also proposed under this Option that ESMA and the relevant NCAs are informed by fund managers when they activate LMTs.[85] NCAs, for their part, would be required to notify ESMA and the ESRB before stepping in for the fund managers to activate LMTs in the public interest, which includes financial stability concerns. In addition, as also recommended by the ESRB, ESMA could be mandated to develop guidance for NCAs to follow/consider when exercising their powers to suspend redemptions or activate redemption gates, in

[83] Annex 8 contains a list of LMTs available in national frameworks, which could serve as a basis.
[84] ESRB 2017 Recommendations (ESRB/2017/6), p. 18, "*Regulators are not usually allowed to activate tools. The general exception to this is the suspension of redemptions, which may be imposed by the regulator if it is deemed to be in the public interest which, presumably, also includes financial stability factors. In a number of jurisdictions NCAs are granted the power to activate redemption gates*". https://www.esrb.europa.eu/pub/pdf/recommendations/esrb.recommendation180214_ESRB_2017_6.en.pdf?c8d7003d2f6d7609c348f4a93ced0add
[85] ESMA points out in its latest Annual Statistical Report on EU AIFs that almost 80% of AIFs do not report data on their special liquidity arrangements. A total of 20% of all AIFs declare that they do not apply LMTs, and only 1% report applying LMTs.

situations where there are cross-border financial stability implications. Indeed, also a significant minority of respondents to the public consultation that favoured enhancing the framework suggested to further detail cooperation of the NCAs in case of activating LMTs.

The departure point for Option 2 is the same: the range of LMTs is widened and harmonised across the Union so that the fund managers based anywhere have the possibility to consider using any of LMTs they deem appropriate by including them into the fund documentation. The difference with Option 1 is that under Option 2 fund managers would be required to include at least a minimum set of several, predetermined LMTs in the fund's constitutional and contractual documents. In addition, to ensure that all LMTs could be applied in the public interest, NCAs would be equipped with the power to activate any type of LMT included in the legal documents of the funds concerned.

Option 2 goes beyond Option 1 and directly imposes on managers of open-ended funds the obligation to include a minimum set of several, predetermined LMTs (e.g. suspensions of redemptions, redemption gates and fees) in their funds' documentation. This would be a major deviation from the current framework under which fund managers are primarily responsible for liquidity management of their investment funds[86] and could raise serious moral hazard concerns.

The industry warns against imposing certain LMTs on managers, for instance EFAMA wrote: 'We would caution however against including restrictive definitions or rules on the deployment of LMTs. The ongoing development of industry standards reflect changes in markets and technology that appears to be more effective than rigid rules on how to apply these tools under stressed market conditions. The choice of tools must be always at the discretion of the manager because of existing different fund types and structures.'

Regardless of these options, the Commission is also likely to request ESMA later to update its technical advice in order to provide further details in AIFMR for determining the liquidity profile of the fund on a regular basis and to promote effective liquidity risk management. Determining which LMTs to be included in the AIFs rules should be an essential part of effective and sound liquidity risk management processes. Therefore, as regards liquidity management processes and systems required to be maintained by the AIFMs further details in this respect are likely to be provided in level 3 guidance by ESMA, in particular in the context of stress testing exercises.[87]

1.2 The impacts of the Options

a) Option 1

<u>PROs:</u> Widening the range of available LMTs and requiring fund managers to include at least one other appropriate LMT in addition to suspension of redemptions in the legal documents of their open-ended investment funds would enable them to better deal with

[86] According to Article 16(2) AIFMD and Article 40(4) of Commission Directive 2010/43/EU, fund managers are required to ensure that liquidity profiles and redemption policies of their AIFs and UCITS are consistent.
[87] Article 16 AIFMD.

fund's liquidity issues, as considered appropriate. Including the possibility for NCAs to impose the activation of redemption gates (in addition to suspension of redemptions) or the LMT obligatorily chosen by the fund manager under stressed market conditions, would enhance supervisory toolkit and give national authorities more flexibility to react to large-scale investor redemptions and to ensure the orderly sale of underlying assets. Obligation to notify activation of LMTs by fund managers and NCAs would increase market transparency and contribute to better coordination among NCAs. In addition, ESMA Guidelines would clarify the role of NCAs and ESMA when fund redemptions are being suspended in public interest with cross-border financial stability implications. This cooperative set-up would facilitate monitoring of systemic risks across the Union and devising appropriate responses thereto in a coordinated fashion, should need be.

CONs: Adjustment of funds' legal documents to include at least one LMT would necessitate one-off compliance cost. Compliance costs for fund managers and NCAs would also marginally increase due to additional reporting obligations.

Impact on investors	• Activating some LMT, instead of just selling assets to fully satisfy redemption requests, would protect the value of investment thus benefiting the investors. • There would be transparency for investors that it is not possible to guarantee absolute liquidity at any market conditions.
Impact on AIF/AIFMs	• Fund managers would be able to better deal with the fund's liquidity issues. • Requiring AIFMs to choose at least one LMT that they deem appropriate will maintain enough of discretion in the hands of AIFMs. • There is a slight risk of moral hazard where fund managers, instead of trying to make sure that liquidity is managed in such a way that the promise to redeem in line with contractual obligations can always be honoured, could become less diligent in managing liquidity risks.
Impact on financial stability	• Enhanced liquidity risk management options for all AIFMs. • The possibility for NCAs to impose the activation of redemption gates (in addition to suspension of redemptions) or the LMT obligatorily chosen by the fund manager would facilitate orderly sale of underlying assets and thus protect interest of all investors. • Notification of the activated LMTs by fund managers and NCAs would increase market transparency while ESMA Guidelines would steer fund suspensions by NCAs in public interest with cross-border implications.

b) Option 2

PROs: The first premise of Option 1 and Option 2 being the same, i.e. that the range of available LMTs should be harmonised at the Union level, Option 2 would open up a more diverse liquidity management options for all fund managers. Requiring minimum set of several, predetermined LMTs to be included in the funds' constitutional documents would permit fund managers to better deal with fund's liquidity issues, as considered appropriate. A larger toolkit at the disposal of supervisors allowing them to deploy the most suitable tool would benefit financial stability.

CONs: Compliance cost to adjust funds' legal documents. Reduced flexibility of fund managers to design products matching their clients' needs. Increased moral hazard concerns as responsibility for liquidity management increasingly passed onto supervisors which may not always be best placed to manage liquidity tensions (liability and know-how issue).

Impact on investors	• Activating some LMT, instead of selling assets to fully satisfy redemption requests, would protect the value of investment thus benefiting the investors. • There is transparency for investors that it is not possible to guarantee absolute liquidity at any market conditions. • An obligatory set of LMTs for all open-ended investment funds without taking into account all the features of the investment vehicle may discourage certain investors as their needs may not be accurately reflected.
Impact on AIF/AIFMs	• Fund managers would be able to better deal with the fund's liquidity issues. • Mandatory imposition of a minimum set of predetermined LMTs would affect managers' flexibility to choose the most appropriate type of LMT depending on specific features of the investment vehicle affecting its attractiveness for the investors. • There would be a risk of moral hazard where fund managers, instead of trying to make sure that liquidity is managed in such a way that the promise to redeem in line with contractual obligations can always be honoured, could become insufficiently diligent in managing liquidity risks.
Impact on financial stability	• Larger liquidity management toolkit would be available for all AIFMs and their supervisors but risk of moral hazard by fund managers would also increase as responsibility for liquidity management would be shared with NCAs. • Notification of the activated LMTs by fund managers and NCAs would increase market transparency while ESMA Guidelines would steer fund suspensions by NCAs in public interest with cross-border implications.

1.3 Comparison of the Options

The following table compares the Options against the objectives listed in Section 4. In addition, it assesses the efficiency and their impact on SMEs. The economic, environmental, social and fundamental rights impacts and coherence with EU policy objectives is also considered.

Objective	Option 1	Option 2
Single market for AIFs	++	++

	Harmonising LMT related rules would contribute to completing an internal market for AIFs.	Harmonising LMT rules would contribute to completing an internal market for AIFs.
Fund managers	++ Better able to deal with high fund outflows	+- Larger toolkit but lower flexibility in designing their funds
Investor protection	++ Investor interests would be better served by preserving value of their investment where possible. Lower risk that the fund would have to be suspended and lower risk of systemic liquidity crisis.	+- Investor interests would be better served by preserving value of their investment where possible. More robust but less diversified offer of fund products.
Financial stability	++ Better liquidity management by fund managers. Enhanced supervisory toolkit and better capability of supervisors to deal with cross-border situations	+- A mandatory set of LMTs may improve but also compromise liquidity risk management by fund managers Larger supervisory toolkit but increased risk of moral hazard by fund managers
Efficiency (cost-effectiveness)	+- Justified changes to the fund	+- Justified changes to the fund

	documentation	documentation
Impact on SMEs	- Costs for all AIFMs including SMEs	-- Costs for all AIFMs including SMEs, potentially higher where the change to the fund documentation is more extensive.
Other economic, environmental, social and fundamental rights impacts	0 No impact	0 No impact
Coherence with EU policy objectives	++ Aligned with overall CMU strategy to continue building internal market for financial services	+ Aligned with overall CMU strategy to continue building internal market for financial services, however, may be judged as disproportionate
Coherence with EU rules	+ Consistent with existing EU rules on acting in the best interest of the client	+/- It would reduce asset managers flexibility in taking decision in the best interest of clients

Legend: +++ = Very positive ++ = Positive + = Slightly positive +/- = Mixed effect 0 = no effect - = Slightly negative -- = Negative --- = very negative

1.4 Costs

LMTs related proposals may create some compliance costs, but these would be limited for following reasons: 1) having internal processes to manage risks, including liquidity risk, is already part of the overall internal/organisational costs related to the risk management and monitoring of certain exposures, linked to the investment strategy of the fund and as set by the AIFMD and UCITSD conduct rules on duties towards investors. Duties towards investors/beneficiaries mean that relevant entities have to take investment decisions in the best interest of their investors or beneficiaries, and in accordance with the mandate received from them. The proposed amendments would induce more harmonisation and make risk management more efficient by making LMTs available anywhere in the Union. The adoption of a common/standardised approach through ESMA guidelines when the LMTs could be activated and what LMTs would be most appropriate is likely to reduce such costs.

In terms of disclosure, based on feedback from the industry from the past public consultations, there are costs attached for updating contractual and pre-contractual documents, prospectuses in particular. An example of one experience is that updating a prospectus costs € 40 000 per product/service. However, feedback received from stakeholders and targeted interviews also highlighted the fact that, because of regulatory changes or other reasons prospectuses of their products are revised anyways at least once every year.

1.5 Preferred Option

Based on the analysis of the available options and taking into account stakeholder feedback, the AIFMD review should proceed with Option 1. This option would ensure that all fund managers in the EU would, in addition to suspension of redemptions, have access to another appropriate LMT while also enhancing supervisory toolkit and addressing coordination issues related to suspensions of redemptions in public interest with cross-border financial stability implications. This would allow to reach the specific objective of harmonising the availability of LMTs across the EU in the most effective way (see Section 4 on the "Objectives"), ensuring coherence with the overall CMU strategy and the existing sectoral EU rules on duties towards investors, while not having the cost of reduced flexibility for fund managers, like under Option 2.

2.1 Options to improve supervisory reporting by providing supervisors with more granular data for market monitoring while removing the reporting duplications for AIFs and UCITS managers

There are two Options considered to address the problem of insufficient data for the purposes of market monitoring.

Option	Description
Option 1: Eliminate restrictions to the granular reporting and mandate ESMA to work out together with the ECB and EIOPA technical feasibility for merging statistical and supervisory reporting	a) Eliminating data provision restrictions in the AIFMD (level 1). b) ESMA together with the ECB and EIOPA assess the technical feasibility of integrating the reporting of supervisory and statistical data by fund managers through developing a common granular reporting template satisfying the needs of the relevant authorities. c) The relevant authorities collect the data jointly and share it among themselves.
Option 2: Impose more granular supervisory reporting requirements and implement IOSCO recommendations on the leverage reporting	a) Eliminating data provision restrictions in the AIFMD (level 1). b) Impose more granular supervisory reporting requirements on AIFMs and also introduce reporting requirements for UCITS c) Fine-tune leverage reporting requirements in accordance with the IOSCO recommendations

Option 1 proposes to prepare the ground for a fundamental overhaul of the AIFMR and UCITS reporting obligations at the EU level. First, it would be necessary to remove the AIFMD level 1 restriction to the data collection, which is limited to the largest exposures, main traded instruments and etc. Level 1 text could simply state that supervisory reporting should be provided in line with level 2 requirements.

Second, it will be necessary to harmonise granular data collection in line with the data needs of the ECB, ESMA, EIOPA and NCAs, potentially creating a centralised data hub accessible to multiple and different users for diverse purposes. This Option proposes to mandate ESMA to assess, together with the ECB and EIOPA[88], the technical feasibility of developing a common reporting template[89] for the reporting of supervisory and statistical data for the use by the relevant authorities, collecting the data jointly and sharing it (potentially from a centralised data hub). Based on the outcome of this assessment, the AIFMR supervisory reporting template could be reformed and a reporting regime for UCITS introduced.

Option 2 would skip the preparatory step aiming to further integrate supervisory and statistical reporting and would require more granular data reporting from AIFMs and would fine tune leverage reporting by taking into account the IOSCO recommendations also introducing supervisory reporting requirements for UCITS.

More specifically, the AIFMD reporting framework would be further enhanced to require reporting of unique entity identifiers (LEI) to facilitate the mapping of AIFMD data with other data sources (such as transaction data under EMIR, MiFID II/ MiFIR, SFTR) and allow authorities to better understand complex fund group structures and interdependencies. A more specific fund classification would be introduced to better reflect the type of funds registered as AIFs. Currently, a category of “other funds”, which comprises mostly equity and fixed income funds, represents around 60% of aggregate net asset value. It would also be helpful to identify MMFs and ELTIFs under the AIFMD. More granular information on fund investments and investors would be introduced to allow authorities to (better) assess the risk of fire sales or disorderly markets and spillovers to financial institutions.

Finally, IOSCO recommends jurisdictions to use and report to IOSCO data on Gross Notional Exposure (GNE) or Adjusted GNE aggregated by asset class. Including Adjusted GNE among the AIFMD leverage measures and collecting data on it, with the breakdown as indicated in the IOSCO Leverage framework, would allow IOSCO to collect consistent data points across the EU and other jurisdictions.

2.2 The impacts of the Options

Option 1: Mandate ESMA to assess technical feasibility and merge statistical supervisory reporting in cooperation with the ECB and EIOPA

<u>PROs:</u> Option 1 is in line with the supervisory data strategy, which spells out the approach to establish a common data space in the financial sector. Therefore, this Option proposes to consider the on-going cross sectoral work in this area and prepare the ground for making supervisory reporting requirements of fund managers part of a more integrated data collection system that would deliver granular, consistent, and timely data

[88] EIOPA needs to collect data, within Solvency II framework, on portfolios of CIU’s invested in by insurance companies.
[89] With aligned data points but not necessarily joint collection of data

to supervisory authorities at EU and national level, while minimising the aggregate reporting costs and burden for all parties.

CONs: It would take longer because this Option would address the issue of significant overlaps between the AIFMR supervisory reporting obligations and reporting to the ECB for statistical purposes. However, this is a necessary interim step to increase granularity of the data reported by AIFMs in an efficient way. This would well inform a potential decision to subject UCITS to harmonised supervisory reporting requirements that would form a part of a more integrated and centralised supervisory reporting space.

Impact on investors	• None for the time being
Impact on AIF/AIFMs	• Lower aggregate reporting costs if more integrated data collection system is subsequently introduced.
Impact on financial stability	• More timely, granular and consistent data accessible by supervisory authorities if more integrated data collection system is introduced • Identified data needs for different public authorities analysed in the feasibility study.

Option 2: Impose more granular supervisory reporting requirements and implement IOSCO recommendations on the leverage reporting.

PROs: Improving fund classification and introducing LEI could improve the supervisory ability to link data and monitor risks at limited costs. More granular information on fund investments and investors would likewise improve the currently constrained ability of supervisors to monitor risks. Integrating the IOSCO recommendations in the leverage reporting would allow investors to compare leverage use by funds heading from foreign jurisdictions. European and foreign supervisors would have a common ground in addressing issues of risk build-up in different markets and globally.

In principle, reporting more granular data should be less costly for fund managers, however, one-off compliance costs would have to be incurred departing from the current requirements to report certain aggregate statistics (which are based on more granular data).

CONs: Option 2 would improve the data coverage for market monitoring. However, it would not remove reporting duplications and would not establish a common data space for the supervisory authorities. These changes would bring significant compliance costs that may need to be incurred yet again when moving towards more integrated data collection system in the future. Interim changes will not justify implementation costs for a short time use of these improvements.

Impact on investors	• Increased market transparency when ESMA processes the received data and issues AIF market reports. • Investors may benefit from a more stable investment fund sector due to better risk monitoring.
Impact on	• One-off compliance costs to adjust the reporting systems. • Limited costs for AIFMs to obtain an LEI (approximately €50-80 per

AIF/AIFMs	year). • Over the medium term reporting more granular data could be less costly for the fund managers that providing certain aggregate statistics (which are based on more granular data) under the current rules.
Impact on financial stability	• Supervisors would access more granular data for market monitoring. • Reporting of LEI would substantially enhance financial stability risk monitoring. • More complete information on fund investments and investors would allow supervisors to better assess the risk of fire sales or disorderly markets and spill-overs to financial institutions.

2.3 Comparison of the Options

The following table compares the Options against the objectives listed in Section 4. In addition, it assesses the efficiency and their impact on SMEs. The economic, environmental, social and fundamental rights impacts and coherence with EU policy objectives is also considered.

Objective	Option 1	Option 2
Fund managers	+- Major change to the supervisory reporting requirements with ensuring compliance costs Time and resource savings when the reporting overlaps are eliminated	- Major change to the supervisory reporting requirements with ensuring compliance costs
Investor protection	+ Investors potentially better informed of the market situation	+ Investors potentially better informed of the market situation

Financial stability	++ More granular data and reporting of LEI for better financial stability risk monitoring Better data availability for and sharing among different authorities	+ More granular data and reporting of LEI for better financial stability risk monitoring
Efficiency (cost-effectiveness)	+- Compliance costs for changing internal systems and obtaining LEI Eliminated reporting duplication would bring efficiencies	- Compliance costs for changing internal systems and obtaining LEI
Impact on SMEs	- Costs for all AIFMs including SMEs	- Costs for all AIFMs including SMEs
Other economic, environmental, social and fundamental rights impacts	0	0
Coherence with EU policy objectives	++ Aligned with the supervisory data strategy	- Not aligned with the supervisory data strategy perpetuating supervisory reporting silos

Legend: +++ = Very positive ++ = Positive + = Slightly positive +/- = Mixed effect 0 = no effect - = Slightly negative -- = Negative --- = very negative

2.4 Costs

The interim step chosen will not produce any costs just yet. It is not possible to estimate what the feasibly study will conclude and therefore to what extent the reporting template would change.

It is very likely, however, that if the ECB statistical reporting requirements and AIFMR supervisory reporting requirements are merged, this could produce one-off costs to move to a single template, but the savings are likely to occur by eliminating the reporting duplications and cutting down on reporting submissions directing the data to a centralised hub. Taking out LEI will result in a limited one-off and on-going cost but this is justified by the financial stability imperative.

2.5 Preferred Option

Based on the analysis of the available options and taking into account stakeholder feedback, the AIFMD review should proceed with Option 1. This option would require a mandate for ESMA to assess technical feasibility and merge statistical supervisory reporting in cooperation with the ECB and EIOPA.

Option 1 is preferable to Option 2 because it proposes a coordinated approach to achieving a comprehensive and integrated data space in the investment fund sector with the ensuing benefits for financial stability while also alleviating the reporting burden for the market participants in the near future.

3.1 Options to ensure the equal treatment of custodians upholding investor protection regardless of the type of entity that safe keeps AIFs' or UCITS assets

There are two Options considered how CSD could be brought into the custody chain along the other custodians.

Option	Description
Option 1: Subject CSDs to the AIFMD and UCITSD rules when they hold in custody funds' assets.	a) Propose to provide in the AIFMD that investor CSDs holding AIF assets are delegates of the depositary. b) Propose to clarify in the UCITSD that investor CSDs holding UCITS assets are delegates of the depositary for the purpose of the UCITSD.
Option 2: Subject CSDs to the AIFMD and UCITSD rules when they hold in custody funds' assets with some facilitation	Subject CSDs to the AIFMD and UCITSD rules when they hold in custody funds' assets but wave ex-ante due diligence requirements for the depositary.

Option 1 would suggest to state clearly in the AIFMD and UCITSD CSDs, acting outside their primary function as market infrastructure, are subject to the delegation rules under the AIFMD. This would ensure level playing field for competing financial intermediaries and a proper communication with the depositary so that the latter could carry out its duties.

CSDs quote their specialised legal framework as sufficient to protect investors. They reject the idea of having to apply the asset segregation rules, which are more detailed for the delegates of the depositaries than for the CSD in many jurisdictions, and they refuse being subject to further obligations allowing the depositary to fulfil its oversight function. Nevertheless, being subject to the CSDR does neither match the asset segregation requirements as laid down in the AIFMD and UCITS, nor ensure the information flow to the depository, nor allow the depositary to fulfil its due diligence and control.

Option 1 is supported by the majority of the stakeholders (approximately 70%). It builds to a large extent on the ESMA opinion (no 34-45-277) and the extensive work performed by ESMA on this topic, including two rounds of consultations, two roundtable discussions with stakeholders/experts and work by a dedicated ESMA Task Force.

Option 1 addresses the issue of uneven playing field among different service providers and also the issue of inhibited depositary duties for the benefit of investors in AIF and UCITS. Nevertheless, it does not take into account the strengths of the CSDs where those could be recognised in adjusting the depositary's duties to the proportionate extent.

The basis of Option 2 is the same as in Option 1 suggesting to subject CSD to the relevant rules of the AIFMD and UCITSD where these entities hold in custody assets of investment funds. It is fully aligned with the ESMA opinion (no 34-45-277). Consequently, it recognises that ex-ante due diligence obligation of such a delegate by the depositary may be unnecessary as a CSD licenced in the Union is properly vetted by the supervisory authorities. Therefore, additional efforts from the depositary in this respect would be superfluous. Option 2 is superior to Option 1 because it is reflects the principle of proportionality of the rulemaking removing unnecessary obligations for the depositaries that would duplicate a more extensive work already carried out by the public authorities.

3.2 The impacts of the Options

Option 1: Subject CSDs to the AIFMD and UCITSD rules when they hold in custody funds' assets.

<u>PROs:</u> Option 1 would put all the custodians would be put at the same footing and would enable the depositary to carry out its duties and fully respecting the AIFMD.

<u>CONs</u>: Depositary would be required to perform ex-ante due diligence of the CSD, which is superfluous given its being vetted by the public authorities, which issues the CSD licence.

Impact on depositories	• Depositaries would be able to carry out their duties by receiving the necessary information flow. • They would do ex-ante due diligence to all third parties, including CSDs, to whom custody of assets is delegated.
Impact on investors	• Improved investor protection as the AIFMD rules apply and the depositary regime would be given a full effect
Impact on CSDs	• CSDs would not experience technical challenges (neither to implement the requested asset segregation nor to transmit the information which enables the depositary to carry out its duties)

	• Legal obligation to cooperate with the depositary.

Option 2: Subject CSDs to the AIFMD and UCITSD rules when they hold in custody funds' assets with some facilitation

PROs: Option 2 would also put all the custodians would be put at the same footing and would enable the depositary to carry out its duties and fully respecting the AIFMD. Depositary would not be required to perform ex-ante due diligence of the CSD, which is superfluous given its being vetted by the public authorities, which issues the CSD licence.

CONs: No notable.

Impact on depositories	• Depositaries would be able to carry out their duties by receiving the necessary information flow. • They would be able to rely on CSD authorisation or recognition when undertaking ex-ante due diligence in case they intend to appoint an investor CSD as delegate
Impact on investors	• Improved investor protection as the AIFMD rules apply and the depositary regime would be given a full effect
Impact on CSDs	• CSDs would not experience technical challenges (neither to implement the requested asset segregation nor to transmit the information which enables the depositary to carry out its duties) • Legal obligation to cooperate with the depositary.

3.3 Comparison of the options

The difference between the two options is that the Option 2 facilitates appointment of CSD as a delegate by allowing depositary to rely on the CSD authorisation or recognition, when performing the ex-ante due diligence requirements as required under the AIFMD. The on-going due diligence requirements as defined in the AIFMD are maintained. The only difference when assessing how well the Options reach the objectives, which are relevant for levelling the playing field for custodians, is that Option 2 proposes a more proportionate solution, as it facilitates/accelerates ex-ante due diligence by the depositary by recognising CSD authorisation or recognition. For this reason, and building on ESMA's Opinion, Option 2 is retained.

The following table compares the Options against the objectives listed in Section 4. In addition, it assesses the efficiency and their impact on SMEs. The economic, environmental, social and fundamental rights impacts and coherence with EU policy objectives is also considered.

Objective	Option 1	Option 2
Level-playing field between entities offering custody	++ Equal level-playing field	++ Equal level-playing field between

services	between custodians and investor CSDs	custodians and investor CSDs
Investor protection	++ Improves investor protection as harmonised AIFMD and UCITSD rules apply	++ Improves investor protection as harmonised AIFMD and UCITS rules apply
Financial stability	0 No impact	0 No impact
Proportionality	0 No impact, as general ex-ante due diligence should be applied by the depositary	+ Facilitates/accelerates ex-ante due diligence check by the depositary
Coherence with EU policy objectives	+ Ensures application of AIFMD and UCITSD, including the strict liability regime	+ Ensures full application of AIFMD and UCITSD, including the strict liability regime

Legend: +++ = Very positive ++ = Positive + = Slightly positive +/- = Mixed effect 0 = no effect - = Slightly negative -- = Negative --- = very negative

3.4 Costs

Depositaries and CSD will have to revise their contractual relationship to ensure the flow of information. This will cause limited one-off costs, which are justified by the imperative of investor protection. Depositaries need to have a contractual relationship with all delegates, no matter which status this entity has.

3.5 Preferred Option

Bringing in CSDs into the custody chain will ensure that depositaries can discharge their duties properly and that under law CSDs will be obliged to ensure a proper information flow to the depositaries on the fund holdings that the CSDs keep in custody. Is it preferred to favour the Option 2 that reduces unnecessary burden for the depositaries and also for the CSDs when appraising the suitability of such custodians.

Part B: Technical clarification of the current rules

The proposal will also contain technical updates of the cross-references and technical clarifications of the existing rules learning from the discussions in ESMA and relying on the legal interpretation of the current provisions by the European Commission.

ANNEX 7. THE MAIN FEATURES OF A SELECTION OF NATIONAL LOAN ORIGINATING FRAMEWORKS

In April 2016, ESMA published an opinion on the *Key principles for a European framework on loan origination by fund*. This opinion contained a survey which results are summarised below:

Table 3: Loan originating national practices

	Is loan origination by funds allowed in NCAs jurisdiction?	Do NCAs have a specific legal framework for that activity?
Yes	80,0%	33,3%
No	16,7%	70,8%
N/A	3,3%	16,7%

Source: ESMA opinion (ESMA/2016/596) Key principles for a European framework on loan origination by funds, April 2016 (Answer for France has been updated).

Annex of *ESMA opinion* (*ESMA/2016/596*) – Mapping on national practices as to loan-origination by funds

	Is loan origination by funds allowed in your jurisdiction?	**Do you have a specific legal framework for that activity?**	**What are the main features of the legal framework (i.e. maximum leverage, types of fund, types of investor etc.)?**
Belgium	Yes	No	N/A
Bulgaria	No	No	N/A
Czech Republic	Yes but no as a main strategy of AIFs because systematic origination of loans is not in the scope of collective investment in Czech Republic.	No	N/A
Denmark	Yes	No	N/A
Germany	Yes	The UCITS V implementing Act, which includes rules on loan origination, will come into force on 18th March 2016.	http://www.bundesfinanzministerium.de/Content/DE/Gesetzestexte/Gesetzentwuerfe_Arbeitsfassung en/2015-09-24-OGAW.html
Estonia	Yes	No	N/A
Ireland	Yes	Yes	http://www.centralbank.ie/regulation/industry-sectors/funds/aifmd/Documents/AIF%20Rulebook%20November%202015%20Final.pdf See pages 146-152
Greece			
Spain	Yes	Yes	Closed ended funds: • Private equity and venture capital funds: they are allowed to grant loans. These funds may be marketed to professional or semi-professional investors (100.000€ and state in writing that they are aware of the risks associated with the envisaged commitment.) • Other categories of close-ended funds (called "Entidades de Inversion colectiva cerradas" or EICC): There are no specific limitations as regards their investments so they can grant loans. Marketing is only allowed to professional investors. Open ended loan - originating funds. • leverage is not allowed (neither form the public nor from banks) • It is possible to set up a lock up of the same length of the life of the loans granted • There are specific organizational requirements for managers regarding credit scoring. They must set up a due diligence procedure to assess the financial strength of the borrowers (ex ante and on a continuous basis) • Marketing will be possible only to professional

			investors. • These funds cannot grant credits to related parties, to natural persons, or investors of the fund. • The portfolio must be sufficiently diversified at the level of the borrowers and the prospectus must foresee the deadline to meet that diversification. In case the diversification were not attained, the fund should review its strategy and modify it after informing the investors • Information on the specific loans granted must be provided in periodic reports
France	No	N/A	N/A
Croatia	Yes	No	N/A
Italy	Yes	Yes	**Closed ended structure**; **leverage limits** (ratio between total assets and NAV) of 130% for funds marketed to retail public, 150% for funds marketed to professional investors; **derivative contracts** exclusively for hedging purposes; **maturity of the credit** granted by a fund cannot exceed the fund's maturity; **exposure to a single client** up to a limit of 10 per cent of the total assets of the fund. Asset managers are required to define, within the risk management system, a **specific process of managing credit risk**, with particular regard to: i) risk measurement; ii) risk diversification; iii) credit monitoring; iv) classification of risk positions; v) assessment and management of impaired loans (risk management)
Cyprus	Yes	Yes (upcoming legislation)	
Latvia	Yes	No	N/A
Lithuania	Yes	No	N/A
Luxembourg	Yes	No	N/A
Hungary	No	N/A	N/A
Malta	Yes	Yes	Loan Fund Rules published 2nd April 2014 - May only be closed-ended; may only be marketed to professional investors; minimum entry level EUR100,000; Additional requirements apply over and above AIFMD in areas such as credit assessment, liquidity provision, exposure limits and disclosure; may not lend to financial institutions or households; variable NAV; leverage and reuse of collateral not permitted.
Netherlands	Yes	No	N/A
Austria	Yes	No	N/A

Poland	Yes (But only for (i) closed-end funds and (ii) specialised open-end investment funds applying the investment rules prescribed for an closed-end investment fund. In accordance with draft of act implementing AIFMD aforementioned type of funds will be identified as AIFs. Specialised open-end investment fund may apply investment rules prescribed for a closed-end investment provided that its participants may only include: (i) legal persons, (ii) organisational units without legal personality; (iii) natural persons who will make a one-off payment to the fund of an amount not lower than the PLN equivalent of EUR 40,000.)	Yes (very limited) (See art. 113 (3) and art. 153 of Act of 27 May 2004 on Investment Funds)	1) Types of funds (close-end, specialised open-end investment funds applying the investment rules prescribed for an closed-end investment fund), 2) Restrictions - maximum % share of NAV - total (50%) and single counterparty exposition (20%), 3) Additional requirements - the borrower should enable the fund to assess the borrower's financial and economic situation and to monitor usage and repayment of the loan, - fund's articles of association should define the criteria to be met by the borrower, the terms of the loan repayment and the type and minimum value of collaterals which the fund should require to be established.
Portugal	No	No	N/A
Romania	No	N/A	N/A
Slovenia	Yes	Yes	New rules on loan originating came into force on 16.2.2016 - allowing loan originating when the investment strategy of fund is aimed at financing SME's. Maximum leverage is 2, no short selling is allowed, derivatives are allowed only for hedging the risks. Marketing is only allowed to investors who invest at least 50,000 EUR and accept the risks of the investment in separate written document.
Slovakia	Yes, it is allowed as the part of investment strategy in line with the best interests of investors, not as the main activity of the fund	No	N/A
Finland	Yes	No	N/A
Sweden	Yes	No	N/A
United Kingdom	Yes, but these funds are not marketable to the general public.	No	N/A
Iceland	Yes	No	N/A
Liechtenstein	Yes	No	N/A
Norway	No	N/A	N/A

Table 4: Loan Origination by Investment Funds, Discussion Paper, Central Bank of Ireland July 2013

	France	Germany	Italy	Ireland	Spain	Belgium	The Netherlands	Luxembourg
Fund Structure	Closed and domiciled in France or otherwise rely on ELTIF regime.	Closed Spezial-AIF for professional/semi-professional investors.	Closed.	Closed ended with finite life. Distributions and redemptions may be allowed out of unencumbered cash and available liquid assets.	Open ended.	None.	Closed or in limited circumstances open with redemption arrangements matching liquidity of underlying loans.	Closed or open-ended Lux AIF.
Leverage Limits	30% of NAV for cash borrowings only.	For German AIFs 30% of net capital. For other AIFs, subject to AIFMD tests.	130% for retail investor funds/150% for professional funds.	Gross assets must not exceed 2005 of NAV.	Borrowing not permitted for loan originating funds but use of leverage through derivatives is permitted.	None.	None.	None.
Exposure Limits	None.	Loans granted to single borrower cannot exceed 20% of net capital.	Loans granted to single borrower cannot exceed 10% of total assets.	Loans granted to single borrower cannot exceed 25% of net assets.	Sufficiently' diversified portfolio but no fixed borrower limits.	None.	None.	Specific to funds regime - eg. Cannot exceed 30% of gross or net assets for SIFs and RAIFs.
Maturity and lock-ups	Loans can only be sold during life of fund with approval of AMF or specific circumstances.	None.	Credit maturity cannot exceed fund's maturity.	None.	Use of lock-up periods is allowed that may be extended to match maturity of loans.	None.	None.	None.
Risk Management	Specific credit files must be held. Loan decision procedure must be formalized.	Must have adequate structures and procedures for credit processing, management of NPLs and early detection of risks.	Define process for managing credit risk.	Special risk management, assessment, credit granting, monitoring and valuation procedures.	Risk management shall monitor non-fulfillment of commitments to repay cash or deliver securities. Periodic simulation exercises to assess impact of adverse market conditions.	None.	Credit manager must take general regulatory requirements into account including those dictated by the AIFMD.	In addition to general AIF requirements and investment fund laws, must: address risks of originatiion activity, avail of proper organisational and governance structures with approriate technical and human resources with focus on credit and liquidty risk management, concentration, avoidance of conflicts of interests and proper disclosure and transparency.
Credit Restriction	Lending to credit institutions and CI schemes prohibited.	No lending to consumers and diversification requirement for credit positions.	May only take loans from banks, Art. 106 financial intermediaries and other entities duly authorised to grant loans.	Must limit to issuing loans, participating in loans or lending. May not lend to natural persons, AIFM, depositary or related parties, other CI schemes financial institutions or related companies, investors in equities or traded investments or commodities.	None.	None.	None.	None.
Other Features	Derivative contracts only for hedging.	Some exceptions for funds granting loans to companies in which they hold shares.	Derviatives only for hedging, restrictions on transactions with related parties and limits on fund issuing guarantees.	Restrictions on acquiring loans from credit institutions, retaining exposures correlated to performance of loan or providing admin, credit assessment or monitoring service unless certain conditions met.	Only available to professional or 'qualified' investors.	Consumer, mortgage and SME lending are specifically regulated.	None.	None.

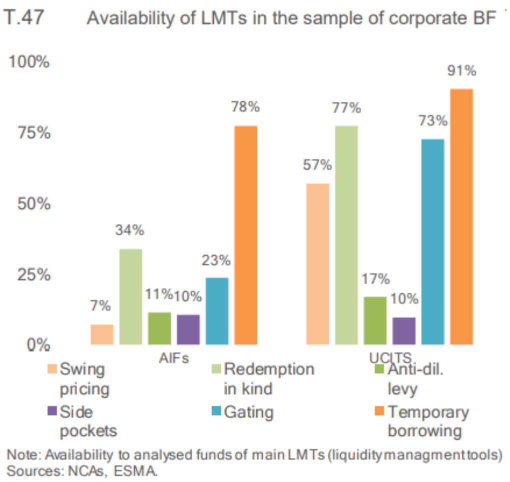
ANNEX 8. MAPPING OF LIQUIDITY MANAGEMENT INSTRUMENTS AVAILABLE FOR AIFMS IN NATIONAL FRAMEWORKS

	AT (1)	BE (2)	BG (3)	CY (4)	CZ (5)	DE (6)	DK (7)	EE (8)	ES (9)	FI (10)	FR (11)	GR (12)	HR (13)	HU (14)	IE (15)
Gates	YES	YES	NO	YES	NO	YES	NO	NO	YES	YES	YES*	NO	*	NO	YES
Side pockets	YES	YES	NO	YES	NO	NO	NO	NO	YES	NO	YES*	NO	*	NO	YES
Anti-dilution levy	NO*	YES	NO	NO	NO	NO	NO	NO	YES	NO	YES*	NO	*	NO	YES
Redemption fees	YES	YES	NO	NO	YES	YES	YES	NO	YES	YES	YES*	YES	*	YES	YES
Redemption in kind	YES	YES	NO	YES	NO	YES	YES	NO	YES	YES	YES*	NO	*	NO	YES
Suspension redemptions/ subscriptions	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES*	YES	YES	YES	YES
Swing pricing	NO**	YES	NO	NO	NO	YES	NO	NO	YES	YES	YES*	NO	*	NO	YES
Mandatory liquidity buffers	NO	YES	NO	NO	NO	YES	NO	NO	YES	NO	NO	NO	*	NO	YES
Side letters	YES	NO	NO	NO	NO	YES	NO	NO	YES	NO	NO	NO	*	NO	YES

	IS (16)	IT (17)	LI (18)	LT (19)	LU (20)	LV (21)	MT (22)	NL (23)	NO (24)	PL (25)	PT (26)	RO (27)	SE (28)	SI (29)	SK (30)
Gates	YES	YES*	YES	YES	YES	NO	YES	YES	YES		YES	YES	YES	NO**	NO
Side pockets	YES	YES*	YES	YES	YES	NO	YES	YES	YES		NO	NO	YES	YES*	NO
Anti-dilution levy	YES	NO	NO	NO	YES	NO	YES	YES	YES		NO*	NO	YES	NO**	NO
Redemption fees	YES	YES	YES	YES	YES	YES	YES	YES	YES		YES	YES	YES	NO**	YES
Redemption in kind	YES	NO	YES	YES/ NO*	YES*	NO	YES	YES	YES		YES	NO	YES	YES*	NO
Suspension redemptions/ subscriptions	YES	YES	YES	YES	YES	YES	YES	YES	YES		YES	YES	YES	YES*	YES
Swing pricing	YES	NO	YES	NO	YES	NO	YES	YES	YES		NO	YES*	YES	NO**	NO
Mandatory liquidity buffers	YES	NO	NO	NO	NO	NO	YES	NO	NO		NO	NO	NO	NO**	NO
Side letters	YES	NO	NO	YES**	YES	NO	YES	YES	YES		NO	NO	YES	NO**	NO

Source: ESMA34-39-1119

Graph 5



Source: <u>ESMA 50-165-1524 TRV report</u> –Availability of LMTs for a sample of bond funds

There are essentially two main types of LMTs, namely ex ante and ex post tools. Ex ante tools, such as swing pricing and anti-dilution levies, transaction costs are on subscriptions or redemptions rather than existing investors. They can be used to mitigate "first mover advantage" by ensuring that the remaining investors are not disadvantaged by the actions of the redeeming investors. This should, to some extent, remove incentives for investors to "move first" and redeem before others. Ex post tools, such as gates and redemptions in kind, suspension of redemptions, allow fund managers to control or limit outflows and thus have more time and flexibility to ensure the orderly sale of underlying assets, especially in times of stressed market conditions. These tools typically relieve managers from the obligation to immediately sell assets (at or below market prices) in response to redemption requests by investors. Ex post tools are typically employed under stressed market conditions.

Moreover, some LMTs (particularly swing pricing and anti-dilution levies) can be used (and are used by funds in some jurisdictions) to ensure equal treatment of all clients in all situations when there are high inflows/outflows and related transaction costs. From this perspective, it is also important that asset managers across the EU have the same set of tools available so that their clients can choose to invest in AIFs where their investments are managed in line with their needs.

Currently, the availability and implementation of additional LMTs for investment funds varies significantly across EU Member states. While the suspension of redemptions by the fund manager or by the NCA is explicitly allowed under AIFMD, the Directive does not stipulate any other LMT. There are therefore differences in the availability of as well as the specific procedures governing the availability and hence use of additional LMT across jurisdictions (see Table in the Annex with the overview of LMTs across the EU). In its September 2020 report[90] on Trends, Risks and Vulnerabilities, ESMA states that "in light of the deterioration in market liquidity and rising redemption requests [in Spring 2020], asset managers used tools such as gates, suspension of redemption and swing pricing although there is significant variation in the availability of those tools across EU jurisdictions." Ensuring the availability of a diverse and harmonised set of liquidity management tools in all EU Member States would thus increase the capacity of fund managers to deal with redemption pressures even in overall stressed market conditions and thus also to better handle cross-border spill-overs of liquidity tensions. Indeed, in a letter to EVP Dombrovskis in August 2020 on the AIFMD Review[91], ESMA states that "the experience of market dislocation during the on-going COVID-19 crisis also demonstrates the need for all LMTs to be available in all jurisdictions in a consistent manner."

[90] https://www.esma.europa.eu/sites/default/files/library/esma_50-165-1287_report_on_trends_risks_and_vulnerabilities_no.2_2020.pdf (p. 32)
[91] https://www.esma.europa.eu/sites/default/files/library/esma34-32-551_esma_letter_on_aifmd_review.pdf

ANNEX 9. EVALUATION OF THE AIFMD

EUROPEAN
COMMISSION

Brussels, XXX
[…](2020) XXX draft

COMMISSION STAFF WORKING DOCUMENT

EVALUATION

[Optional element]

[Mandatory element]

[Mandatory element]

1. Introduction

The Alternative Investment Fund Managers Directive (AIFMD) was adopted following the global financial crisis of 2008 to improve supervisory oversight of the alternative asset management sector. Whilst seeking to ensure a coherent supervisory approach to the risks of the financial system and to provide a high level of protection to investors, the Union co-legislators also sought to facilitate integration of the AIF market, which was suffering from regulatory fragmentation and thus from hampered development.

The AIFs' universe is heterogeneous in terms of investment strategies, markets, asset types and legal forms. The diverse investment strategies pursued by different types of AIF expose those AIFs and their investors to a wide range of potential risks and may result in specific vulnerabilities in the financial system. The EU co-legislators considered that regulation of the EU alternative investment fund sector could be best achieved by focusing on establishing common requirements for the AIFMs as opposed to their managed AIFs.[92] As a result, the AIFMD governs the authorisation and operation of AIFMs managing all types of AIFs, irrespective of their legal structure or the investment strategy employed, in so far as the managed investment funds are not covered by Directive 2009/65/EC (UCITSD).[93]

The following sections set out the purpose of the AIFMD evaluation (see section 1.1 below), as well as the substantive and geographic scope of the AIFMD evaluation (see section 1.2 below).

1.1 Purpose of the AIFMD evaluation

Under Article 69 AIFMD, the European Commission had to start by 22 July 2017 a review of the application and scope of the Directive, its impact on investors, AIFs and AIFMs, within the EU and in third countries, and the degree to which its objectives have been achieved. The Commission shall, if necessary, propose appropriate amendments.

In this context, KPMG Law Rechtsanwaltsgesellschaft mbH as lead firm, with the subcontractors KPMG AG Wirtschaftsprüfungsgesellschaft, Germany and KPMG LLP, United Kingdom supported by the European network of KPMG, has been mandated by the Directorate-General for Financial Stability, Financial Services and Capital Markets Union (DG FISMA) to conduct a general survey and to carry out an evidence-based study.[94]

The purpose of this evaluation is to gather evidence on the functioning of the AIFMD taking into account its objectives. It will serve as a basis for the Commission to decide whether the Union harmonised approach has caused any ongoing major market disruption and whether or not the AIFMD functions effectively in light of the principles of the internal market and of a level playing field. The evaluation covers the period from the application of the AIFMD on 22 July 2013 to 31 December 2020.

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[92] This shift of paradigm has even prompted some EU Member States to no longer require a separate authorisation for certain types of AIFs, for example, Luxembourg RAIFs.
[93] Article 4(1)(a) of the AIFMD.
[94] KPMG, Report on the Operation of the alternative investment fund managers directive (AIFMD) Directive 2011/61/EU, FISMA/2016/105(02)/C, 7 February 2019 (hereafter: KPMG Report).

As required by the Commission's Better Regulation Guidelines,[95] the evaluation examines whether the objectives of the AIFMD were met during the period of its application (effectiveness) and continue to be appropriate (relevance) and whether the AIFMD, taking account of the costs and benefits associated with applying it, was efficient in achieving its objectives (efficiency). It also considers whether the AIFMD, as legislation at EU level, provided added value (EU added value) and is consistent with other Commission documents providing guidance on the application of the AIFMD and related legislation with relevance for alternative investment fund managers (coherence).

1.2 Scope of the AIFMD evaluation

The <u>substantive scope</u> of the evaluation includes the AIFMD, together with the AIFMR,[96] in their entirety. Insofar as the AIMFR refers to the provisions of the AIFMD and inform their application and interpretation, the assessment of the AIFMD would not be complete if it did not include them.

Since the adoption of the current AIFMD, there have been a number of market developments, notably the withdrawal of the United Kingdom (UK) from the European Union (EU), a process known as Brexit.

The evaluation will focus on the following objectives:

(i) Appropriate authorisation and registration requirements for all AIFMs operating in the EU: specifically this would require all AIFMs to respect and satisfy a common set of requirements (minimum capital, fit and proper, transparency, etc.) before operating across the EU.

(ii) Improved monitoring of macro-prudential risks through the provision of relevant information to prudential authorities. To take due account of the cross-border dimension of these risks, relevant information would need to be pooled at European or global level. At operational level, this objective would require the collection of relevant data on inter alia leverage, trading activity, risk concentrations and performance, and appropriate information-sharing mechanisms to be established.

(iii) Enhanced management of micro-prudential risks through the imposition of strict risk management controls on market, liquidity, counterparty (credit and settlement, especially in case of short selling) and operational risks.

(iv) A common approach to protecting investors in AIFM-managed funds is required, including improvements in investor disclosures to ensure that due diligence can be performed effectively. Ensuring the proper management of conflicts of interest and imposing independent controls and processes in key risk areas, in particular valuation and custody functions, would also help to achieve this specific objective.

[95] Commission staff working document, Better Regulation Guidelines, Brussels, 7 July 2017, SWD (2017) 350.
[96] Commission Delegated Regulation (EU) No 694/2014 of 17 December 2013 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to regulatory technical standards determining types of alternative investment fund managers

(v) Greater public accountability of AIFM investing in and managing companies should be achieved so as to ensure that such activities are subject to an appropriate level of public scrutiny. The operational objective related to this is to impose additional transparency requirements on AIFM when they acquire controlling stakes in companies with the aim to actively engage in and influence these companies' future management.

(vi) The removal of barriers to the efficient cross-border distribution of AIF should allow an internal market in AIF in the EU to develop which is grounded in a robust and consistent regulatory supervisory framework.

It is against these objectives that possible actions in relation to AIFM were proposed in the Impact Assessment.[97]

The geographic scope of the evaluation extends to all EU Member States.[98] By virtue of Article 288 TFEU the AIFMD is binding, as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods.

The three EFTA States (Iceland, Liechtenstein and Norway) are not part of the evaluation since the AIFMD is not directly applicable in these countries. Secondary EU law (such as Commission regulations) first has to be included in the Agreement on the European Economic Area ("EEA Agreement")[99] on the basis of Article 60 of the EEA Agreement and must then be incorporated into the national legal orders of the EFTA States to become applicable. Subject to this process, the AIFMD is applicable in the EFTA States. In view of the Commission's obligation to informally seek advice from experts of the EFTA States for the elaboration of new legislative proposals.[100]

2. BACKGROUND TO THE INTERVENTION

Concerns about AIFs date back to market disruptions prior to the financial crisis in 2007/2008 and centred on the failure of Long-Term Capital Management in 1998. This case highlighted associated risk exposures, market concentrations and the lack of regulatory oversight and – on the basis of an isolated worst-case scenario – brought to regulatory attention that highly leveraged funds contributed to systemic risks.[101]

As a reaction to similar particularities during the financial crisis in 2007/2008, the Bank of International Settlement asserted that hedge funds in particular played a key role in the contribution of systemic risks in the financial system.[102] Similarly, IOSCO concluded that,

[97] See p. 29 IA 2009.
[98] Since the AIFMD has been fully applicable in the United Kingdom during the period under review, the evaluation includes evidence gathered from stakeholders in the UK.
[99] Agreement on the European Economic Area, OJ L 1, 3.1.1994, p. 1, Annex XIV, section B.
[100] Article 99(1) EEA Agreement.
[101] For an extensive overview see D. Zetzsche (2015). Introduction: Overview, Regulatory History and Technique, Transition, in: D. Zetzsche (ed.), The Alternative Investment Fund Managers Directive (2nd edn); T. Bernhardt (2013). The European Alternative Investment Fund Managers Directive (AIFMD) - an appropriate approach to the global financial crisis? Lohmar: Josef Eul Verlag.
[102] Bank of International Settlement (BIS) (2010). Review of the Differentiated Nature and Scope of Financial Regulation; McGuire, Patrick, & Kostas Tsatsaronis (2008). Estimating hedge fund leverage. BIS Working Papers No. 260. Bank for International Settlements. Retrieved from https://www.bis.org/publ/work260.htm; R.

inter alia, the extensive use of leverage by investment funds amplified the final stages of the crisis.[103] Subsequently, the G20 Summit in Washington in 2008, as well as further summits,[104] pointed to the necessity of a harmonised and consistent regulation and supervision of every participant and product in financial markets.[105] Advancing this policy approach, the Financial Stability Board (FSB) captured the G20 rationale and propelled an action plan of reforms to the financial system, particularly emphasising the resilience, capabilities and trends in non-bank financial intermediation.[106]

In the EU, the High-Level Group on Financial Supervision, chaired by Jacques de Larosière, considered these issues and recommended to the EC "*extending appropriate regulation, in a proportionate manner, to all entities conducting financial activities of a potentially systemic nature, even if they have no direct dealings with the public at large*".[107] The group emphasised the regulation of the managers rather than the funds and proposed relevant measures to prevent regulatory arbitrage.

In addition, the close connection of a UCITS with entities linked to Bernard Madoff's Ponzi scheme in the US called into question the adequacy of the depositary provision in UCITSD. This concern led to significantly enhanced provisions for UCITS, but prior to that gave rise to calls for AIFs also to be required to have a depositary. Against this backdrop, in 2009 the EC issued a proposal to regulate AIFMs, which was adopted in June 2011.

The AIFMD Impact Assessment identified important gaps and weaknesses in European and national approaches to the regulation and supervision of the AIFM sector. The activities of AIFMs were considered by the European Commission to be associated with the following risks for AIF investors, counterparties, the financial markets and the wider economy:

Macro-prudential (systemic) risks

The financial crisis had exposed important weaknesses in existing systems of macroprudential oversight, in particular in relation to those AIFMs that make systematic use of leverage and take large positions in key financial markets (primarily hedge funds and some

Zepeda (2014). To EU, or not to EU: that ls the AIFMD question. Journal of International Banking Law and Regulation 29 (2), 82-102.

[103] IOSCO (2009). Hedge Funds Oversight – Final Report. Retrieved from https://www.iosco.org/library/pubdocs/pdf/IOSCOPD293.pdf

[104] The Washington Summit Declaration (November 2008) advocated a holistic regulation of the financial industry. The London Summit Declaration (April 2009) included an extensive set of actions referring to regulation and supervision of systemically important financial institutions, markets, and instruments (in particular, a mandatory authorisation of asset managers) so as to promote a sound and resilient risk management. The Pittsburgh Summit Declaration (September 2009) and Toronto Summit Declaration (June 2010) paved the way for global financial services regulation and specifically mandated the regulation and supervision of the alternative investment fund industry; see D. Zetzsche (2015). Introduction: Overview, Regulatory History and Technique, Transition, in: D. Zetzsche (ed.), The Alternative Investment Fund Managers Directive (2nd edn) with various further references.

[105] Rf. see D. Zetzsche (2015). Introduction: Overview, Regulatory History and Technique, Transition, in: D. Zetzsche (ed.), The Alternative Investment Fund Managers Directive (2nd edn) with various further references.

[106] Rf. FSB (2011). Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability: Report to G20 Finance Ministers and Central Bank Governors. Retrieved from http://www.fsb.org/2014/11/overview-of-progress-in-the-implementation-of-the-g20-recommendationsfor-strengthening-financial-stability-5/.

[107] Report of the High-Level Group on Financial Supervision in the EU (February 2009). Retrieved from https://ec.europa.eu/info/system/files/de_larosiere_report_en.pdf, 25.

commodity funds). Given the cross-border nature of these risks, the inability to piece together a comprehensive picture of AIF leverage and AIFM activities in all major European markets was a major flaw in existing systems of macroprudential oversight.

Micro-prudential risks

The financial crisis had also highlighted failings in risk management and due diligence. The management of liquidity risks had posed a particular problem for some AIFs, where the combination of illiquid investments and pressure for deleveraging and investor redemption had exposed a severe liquidity mismatch. In the hedge fund sector in particular, counterparty risk management systems had been tested by the failure of significant counterparties. The illiquidity of key asset markets had exposed weaknesses in valuation processes and methodologies. Effective management of the cross-border dimension of these risks was thought to necessitate a common understanding of the obligations of AIFMs and clear arrangements to support supervisors in ensuring that risk management systems are sufficiently robust.

Market efficiency and integrity

AIFMs, in particular hedge fund managers, were central to the debate about the impact of certain trading practices on the integrity of financial markets. The activities of concern included short selling and the impact on commodity (especially food) prices of speculation in the futures markets.

Three further risks were considered by the European Commission:

Investor protection

Most Member States had in place NPPRs, but these varied as to who was eligible to invest and as to the products that could be promoted. The importance of ensuring an appropriate level of investor protection had grown as the investor base of AIFs had expanded to include pension funds, insurance companies and some public authorities, which invested on behalf of a very broad investor base. The quality and content of the information provided to investors varied considerably, depending in particular on the nature of the AIFM. Therefore, an increased demand for transparent information for investors emerged.

Impact on market for corporate control

Some AIF strategies entail the acquisition of stakes in listed companies and an active role in the governance of those companies. Some hedge fund activities include techniques that allowed investors to build stakes in listed companies in a manner that was thought not to be sufficiently transparent to company management and was detrimental to the interests of other stakeholders. Examples of such techniques included the practice of voting on borrowed stocks and the use of certain derivative instruments, such as contracts for difference. While such techniques were employed by certain categories of AIFM (notably, hedge funds), they were widely available to all market participants.

Acquisition of control of companies by AIFM

In the context of the financial crisis and tightening credit conditions, concerns had arisen in relation to the sustainability of debt assumed by private equity portfolio companies. This had been a particular concern for companies subject to leveraged buy-outs by private equity firms. Similar problems were experienced elsewhere in the financial system. An additional concern related to the treatment of employees when a company was acquired by private equity, namely that employees did not enjoy the same protection and rights as when a transfer of undertaking occurred. The existing regulatory framework and industry codes governing disclosure and information provisions of AIFMs did not sufficiently address the cross-border character of private equity transactions. Furthermore, there was no consistent standard for the level of transparency required in relation to such deals.

AIFMD aimed to provide a coherent approach to the risks identified in the preceding AIF and AIFM market analysis. To this end and as the Directive's ultimate core objective, AIFMD sought to establish a secure and harmonised EU framework for monitoring and supervising the risks that AIFs and AIFMs pose to their investors, counterparties, other financial market participants, financial integrity and stability.

These objectives are illustrated in the recitals of AIFMD:

"The impact of AIFMs on the markets in which they operate is largely beneficial, but recent financial difficulties have underlined how the activities of AIFMs may also serve to spread or amplify risks through the financial system. Uncoordinated national responses make the efficient management of those risks difficult." (Recital 2)

"This Directive aims to provide for an internal market for AIFMs and a harmonized and stringent regulatory and supervisory framework for the activities within the Union of all AIFMs." (Recital 4)

In the light of these policy objectives, AIFMD may be seen as the provider for an internal market for AIFs and a harmonised single rulebook for AIFM activities within the EU/EEA, regardless of whether the AIFM has its registered office in a Member State (EU AIFM) or in a third country (non-EU AIFM).[108]

Another goal of AIFMD was to permit AIFMs, subject to compliance with strict requirements, to provide services and to market their funds across the internal market.

In addition to these core objectives, AIFMD aimed to bring specific and operational objectives to the core of the EU alternative investment industry.

Baseline and points of comparison

Before implementation of AIFMD, there was no overarching regulation of AIFMs at a European level. Regarding collective investment vehicles, there was only UCITSD, which does not apply to AIFs or their managers.

[108] cf. G. Sagan (2014). Alternative Investment Fund Managers Directive Impact on Non-EU Managers. Rev. Banking & Financial Law, 34, 506 et seq.

AIFMs were subject to EU rules that apply to all market participants, such as the Anti-Money Laundering Regulation or the Market Abuse Regulation, and listed funds were subject to disclosure requirements under the Prospectus Directive. The marketing or selling of AIFs was subject to the Investment Services Directive and its subsequent incarnation, MiFID – now MiFID II. Also, according to the AIFMD Impact Assessment, many Member States imposed regulations on AIFMs or on AIFs (especially those available to retail investors, i.e. product regulation) or both.

The main point of comparison for the evaluation is the hypothetical situation of not having an AIFMD in place. The evaluation therefore looks at the functioning of the AIFMD as compared to a situation in which an internal market for EU and non-EU AIFs as well as a harmonised and stringent regulatory and supervisory framework for AIFMs would have been developed only in light of other EU guidance, relevant case law at EU and national level, as well as the enforcement practice of the Commission and the national supervisory authorities.

Given that AIFMD was implemented as a consequence of the financial crisis in 2007/2008, it makes it hard to assess any 'no EU policy' scenario: in reaction to the crisis, many international programmes had been established in order to save and strengthen the international financial system or to avoid another bankruptcy after the crash of Lehman Brothers.

Consequently, in the absence of a coherent EU-wide system, national improvements of any respective domestic AIFM or AIF regulation would almost certainly have been developed in a number of national markets. This would have led to the result that the already heterogeneous and diverse regulatory landscape of AIF regulations would have become even more diverse. A coordinated approach by all Member States to establish a common framework would have required an even greater effort and still would have had limited effects.[109]

The AIFMD impact assessment also assessed several scenarios (under point 5.4 of that document). One of those scenarios considered what would happen without any targeted action regarding the regulation of AIFMs. The impact assessment indicated that although the behaviour of some AIFMs would possibly change in the light of the financial crisis (also due to the loss of investor confidence), the underlying risks associated with the AIFM industry would remain. The impact assessment also pointed out that the incomplete and fragmented national regulatory framework would not be an appropriate foundation for the European financial market.

Furthermore, the impact assessment examined a scenario of "self-regulation" by the AIFM industry. Such self-regulation, at national, EU or international level, could, for example, include best practice lists, codes of conduct or guidelines. However, the impact assessment indicated that one of the main drawbacks of self-regulatory measures is that they are not legally binding and, therefore, are not as effective as regulation. In addition, the impact assessment indicated that the risks of the AIFM industry were not fully covered by the existing self-regulatory measures.

[109] EC Impact Assessment, p. 38, No. 5.4.

As a consequence, the Commission concluded that either doing nothing or relying on self-regulation or national measures would be much less effective than a consistent, coherent approach of harmonisation of law at EU level.

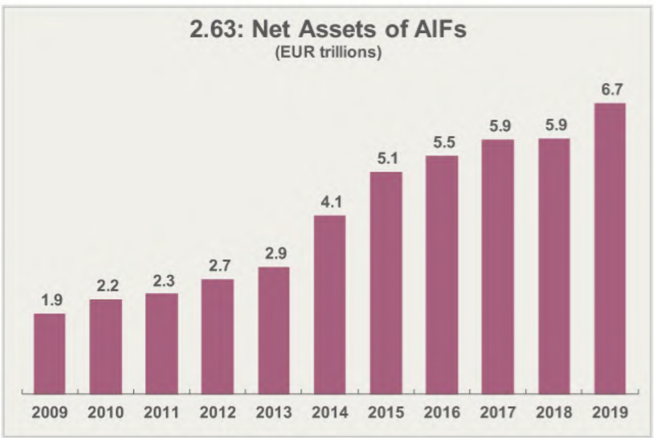
The pre-AIFMD landscape across Member States was heterogeneous across all aspects: investor types, asset classes, investment and redemption strategies, legal and governance structures, form of manager regulation, depositary or custody requirements, valuation and accounting practices, and transparency. The co-legislators recognised this high level of heterogeneity and adopted a Directive that regulates the management company and not the fund itself (i.e. AIFMD is not product regulation). AIFMD therefore regulates only some of the aspects noted above and leaves a number of areas to national discretion, in particular for AIFs marketed to retail investors within the Member State.

The general objective of AIFMD is to create an internal market for EU and non-EU AIFs, and a harmonised and stringent regulatory and supervisory framework for AIFMs. Specifically, it seeks to ensure that all AIFMs are subject to appropriate authorisation and registration requirements; that there is proper monitoring of macro- and micro-prudential risks and a common approach to protecting professional investors; that there is greater accountability of AIFMs holding controlling stakes in non-listed companies; and the development of the Single Market in AIFs.

Description of the current situation

According to the available data, the EU asset management industry has grown significantly since the adoption of the AIFMD (see Table 1). At the end of 2018 the net assets of EU investment funds (UCITS and AIFs) reached a total of € 15.2 trillion, of which 39% or € 5.9 trillion is invested in 28,600 AIFs as compared to 27% or € 2.3 trillion in 2011 and to 27% or € 1.6 trillion in 2008. AIF assets have recorded continuous growth rates virtually every year since 2008 more than doubling in the period between the adoption of the AIFMD and now.

Table 1. AIFs Net Assets



Source: EFAMA Fact Book 2020, page 34.

The EU AIF industry is concentrated in a few countries – Germany, France, the Netherlands, Luxembourg and Ireland – accounting for more than 82% of the net assets of the industry. At the end of 2018 the share of net assets of AIF market of Germany stood at 29%, 18% was the share attributable to France, whereas the shares of Netherlands, Luxembourg and Ireland were 13%, 12% and 10% respectively. In 2018, the strongest growth rates in AIFs net assets were registered in Cyprus (48%), Czech Republic (32%), Greece (14%) and Malta (11%).

The EU AIF market is very diverse in terms of types of funds, strategies and risk profiles of AIFs. The ESMA Statistical Report 2020 shows that limitations in categorising AIFs, dictated by the reporting template contained in the AIFMR, allow for only a crude breakdown of the EU AIF market. Notably, besides funds of funds, real estate funds, hedge funds and private equity funds there were 15,180 "other types" of funds, which have predominantly fixed income or equity strategies or a strategy that does not explicitly fall within the established categories.

In terms of geographical focus, EU AIFs invest mainly in the EEA (63%), followed by North America (16%) and supranational issuers (9%).

Table 2: EU Alternative Investment Funds: essential statistics and market structure in 2018[110]

[110] ESMA Statistical Report 2020, p. 6.

EU AIFs: Essential statistics

	Funds of Funds	Real Estate	Hedge Funds	Private Equity	Other AIFs	All AIFs
Size						
Number of funds (Absolute number)	5,430	3,442	1,449	4,369	15,180	30,357
Number of leveraged funds (Absolute number)	325	1,112	568	91	2,495	4,591
Net Asset Value (EUR bn)	841	731	333	352	3,553	5,860
Average fund size (EUR mn per fund)	150	210	230	80	230	190
Proportion of total market (NAV % of all AIFs)	14%	12%	6%	6%	62%	100%
Distribution						
EU passport (% of total)	76%	75%	30%	60%	80%	76%
Retail participation (% of total)	30%	21%	2%	5%	16%	16%
Exposures						
Main exposures (Asset type)	CIU	PA	IRD	S	S	IRD
Main exposures (% of exposures)	72%	68%	81%	79%	59%	57%
Leverage						
Gross leverage (% of NAV)	118%	132%	5,514%	113%	162%	442%
Adjusted leverage (% of NAV)	118%	130%	1,052%	113%	148%	163%
Borrowing (% of NAV)	1%	8%	284%	3%	5%	21%
Liquidity						
Open ended AIFs (% of total NAV)	71%	52%	78%	5%	69%	65%
Monthly portfolio liquidity (% of NAV)	77%	4%	39%	0%	85%	61%
Monthly investor liquidity (% of NAV)	70%	16%	28%	3%	74%	61%

Note: All values refer to AIFs managed and/or marketed by EU AIFMs at the end of 2018, AIFs reported to ESMA by National Competent Authorities (NCAs). AIFs sold under a National Private Placement Regime (NPPR) are excluded. Statistics for all EU AIFs include 487 funds with no predominant type, for which NAV amounts to EUR 49bn. Open ended AIFs are funds that issue shares which are redeemable on demand by investors. CIU=collective investment units; PA=Physical assets; IRD=Interest rate derivatives; S=Securities.
Sources: AIFMD database, National Competent Authorities, ESMA.

The ownership of AIFs assets tends to be concentrated: the top five investors account for about 75% of NAV on average.[24] This pattern applies across AIF types, except for private equity funds, which tend to have less concentrated investor profiles. One possible explanation for such a high degree of ownership concentration in the EU AIF sector is that professional investors tend to be the main investors in AIFs and they typically hold large stakes in funds they invest in. When non-UCITS funds set up under the national law were later captured by the AIFMD and qualified as AIFs this produced a picture of a highly concentrated AIF market.

As regards investor categories, professional investors account for around 84% of AIFs' NAV, while the retail investors account for the remaining 16%. Retail clients' participation in the alternative investment market appears more significant in segments such as real estate and funds of funds where retail investors account for 21% and 30% of the NAV respectively. It is observed that since 2013, both institutional and retail clients have been increasingly migrating away from traditional actively managed strategies towards low-fee passive strategies or alternative asset classes.

In terms of leverage[111], based on the reported outcomes under the gross and commitment methods of the AIFMR, most AIFs do not appear to engage substantial leverage with the exception of hedge funds. Comparing ESMA statistics for 2017 and 2018, leverage was stable for most types of AIFs, except for hedge funds. Hedge funds gross leverage has reportedly increased from 730% to 1050% between 2017 and 2018, which is partly explained by the reliance of some strategies on derivatives. Data shows that hedge funds use synthetic leverage through derivatives, in particular interest rate derivatives[112], as opposed to financial leverage (borrowing of money to acquire assets), although the latter stood at 160% of the NAV at the end of 2018.

It also is noteworthy that the hedge fund market is also composed of non-EU AIFs, which are marketed almost exclusively to professional investors (98%) in individual Member States through national private placement regimes.[113] ESMA concludes that 40% of investors investing through national private placement regimes cannot be identified. At the end of 2018 the NAV of hedge funds marketed in the Union by the EU AIFMs stood at € 333 billion. Non-EU Hedge funds marketed by non-AIFMs through national private placement regimes in 2018 had a NAV of € 463 billion. The UK is the main domicile for hedge funds with more than 80% of the NAV managed by the UK based AIFMs. Also, according to 2018 ESMA data, the majority of hedge funds are domiciled in the Cayman Islands and marketed in the UK.

As regards liquidity mismatches, in most EU AIFs they are not significant. However, it is observed that certain open-ended AIFs, such as real estate and private equity funds, invest in inherently less liquid assets, such as physical properties or securities of private (un-listed) companies, with the result that some cases exhibit maturity mismatches. According to the liquidity profile of these AIFs, investors are entitled to redeem 28% of the NAV within a day, however, only 26% of the assets could be liquidated to meet these redemption requests.

3. Method

3.1 Short description of methodology

The evaluation study was conducted between December 2020 and June 2021, under the guidance of an inter-service group (ISG) and in the framework of the terms of reference. The methodology included analysis of available documentation and data, and consultation of EU stakeholders. The evaluation report was prepared in line with EU guidelines (including the 'evaluation toolbox').

The evaluation was supported by a study that was carried out by an external consultant – KPMG.[114] It conducted a General Survey and evidence-based study providing a comprehensive assessment of the AIFMD.[115]

[111] Article 4(1)(v) of the AIFMD defines leverage as 'any method by which an AIFM increases exposure of an AIF it manages whether through borrowing of cash or securities, or leverage embedded in derivative positions or by any other means'.
[112] ESMA Statistical Report 2020, p. 41.
[113] ESMA Statistical Report 2020, pp. 22 and 31
[114] KPMG Law Rechtsanwaltsgesellschaft mbH as lead firm, with the subcontractors KPMG AG Wirtschaftsprüfungsgesellschaft, Germany and KPMG LLP, United Kingdom supported by the European network of KPMG.

The KPMG findings are complemented by other sources of information, including relevant data updates and information yielded through various work streams of the Directorate General for Financial Stability, Financial Services and Capital Markets Union (FISMA),[116] the European Securities and Markets Authority (ESMA)[117] and the European Systemic Risk Board (ESRB).[118] The Commission's interaction with stakeholders, comprising national competent authorities (NCAs), industry representatives and investor protection associations, through public consultations, bilateral and multilateral meetings also contributed to the process. Specific examples of the application of the Union rules were taken into account. Academic and statistical publications further informed this evaluation. For example, ESMA's Annual Statistical Reports on EU AIFs was particularly useful in describing the EU AIF market.[119]

On 27 September 2019, the Commission consulted the Expert Group of the European Securities Committee (EGESC) representing the Member States to receive technical and policy feedback on the application and the scope of the AIFMD, including suggestions for improving the legal framework. The European Parliament, the Council, ESMA and the European Central Bank (ECB) are observer members of the EGESC and were invited to participate. EGESC members, i.e. the EU Member States, were also invited to make written submissions, which were taken into account.

On 22 October 2019, the Commission presented the key elements of this report to the ESMA Investment Management Standing Committee (IMSC) and sought its input drawing on the supervisory experience of NCAs.

On 10 June 2020, the European Commission submitted its report to the European Parliament and the Council assessing the scope and the functioning of the AIFMD.[120] The report concludes that while the AIFMD has contributed to the creation of the EU AIF market, provided a high-level protection to investors and facilitated monitoring of risks to financial stability, there are a number of areas where the legal framework could be improved. Further details on the reached conclusions are presented in the European Commission staff working document.[121]

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[115] The General Survey took the form of an online questionnaire, which was running between 6 February 2018 and 29 March 2018. When carrying out the survey, KPMG was guided by a list of aspects laid down in Article 69(1) of the AIFMD on which stakeholders were invited to share their experiences.

[116] Responses to the Commission's Call for Evidence on the EU Regulatory Framework for Financial Services, responses to the Commission's Consultation on Cross-Border Distribution of Funds (UCITS, AIF, ELTIF, EuVECA and EuSEF) across the EU.

[117] Opinion of ESMA on the functioning of the AIFMD passport and expected opinion on asset segregation, figures received by ESMA from NCAs on the use of National Private Placement Regimes, 30 July 2015, ESMA/2015/1235; ESMA thematic study among National Competent Authorities on notification frameworks and home-host responsibilities under UCITS and AIFMD, 7 April 2017, ESMA 34-43-340.

[118] Recommendation of the European Systemic Risk Board of 7 December 2017 on liquidity and leverage risks in investment funds ESRB/2017/6, 2018/C 151/01.

[119] ESMA Annual Statistical Report EU Alternative Investment Funds 2019, 21.01.2019, ESMA 50-165-748. (ESMA Statistical Report 2019) and ESMA Annual Statistical Report EU Alternative Investment Funds 2020, 10.01.2020, ESMA50-165-1032, (ESMA Statistical Report 2020).

[120] REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL assessing the application and the scope of Directive 2011/61/EU of the European Parliament and of the Council on Alternative Investment Fund Managers. COM/2020/232 final

[121] COMMISSION STAFF WORKING DOCUMENT Assessing the application and the scope of Directive

Between 22 October 2020 and 29 January 2021, a public consultation was running and aimed to gather views from the AIFMs, AIF distributors, industry representatives, investors and investor protection associations, financial markets authorities and citizens on potential changes to the AIFMD. Given the European Commission's ongoing efforts to develop the capital markets union (CMU), this consultation sought the views of stakeholders on how to achieve a more effective and efficient functioning of the EU AIF market as part of the overall financial system. It yielded over 130 responses.[122] In addition, the Commission organised a virtual conference on the AIFMD review involving MEPs, NCAs, ESRB, ESMA, representatives of the industry and investor interests to discuss the future of the AIFMD.[123]

3.2 Limitations and robustness of findings

The findings of the study are robust and reliable. The methodology for this evaluation included a review of literature and data, and consultations (some face to face, and some remotely) with stakeholders in the EU. In addition, secondary sources analysis and literature review complemented data from interviews.

4. Analysis and answers to the evaluation questions

The evaluation of the AIFMD is structured around the five assessment criteria defined by the Better Regulation guidelines (effectiveness, efficiency, relevance, coherence and EU added value).

4.1. Effectiveness

How effective the AIFMD has been can be assessed from the relation between the effects observed and the objectives formulated in the 2009 AIFMD Impact Assessment:

(i) appropriate authorisation and registration requirements for all AIFMs operating in the EU
(ii) improved monitoring of macro-prudential risks
(iii) enhanced management of micro-prudential risks
(iv) a common approach to protecting investors in AIFM-managed funds
(v) greater public accountability of AIFMs investing in and managing companies
(vi) the removal of barriers to the efficient cross-border distribution of AIFs

The effectiveness analysis looks at whether the objectives of the AIFMD have been met, and hence looks at what has been the impact of the initiative compared to a situation without it. At the same time, the analysis looks at whether there is still room for improvement in meeting the objectives.

2011/61/EU of the European Parliament and of the Council on Alternative Investment Fund Managers. Brussels, 10.6.2020 SWD(2020) 110 final.

[122] https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12648-Alternative-Investment-Fund-Managers-review-of-EU-rules/public-consultation

[123] A recording of the virtual conference on the AIFMD review [https://ec.europa.eu/info/events/finance-201125-aifmd-review_en].

Based on available evidence, it appears that the Directive has been largely effective in meeting the objectives specified in Section 2, although there are areas that require further work. The analysis below is based on the comparison between the objectives and the extent to which they have been achieved after the implementation of the provisions.

4.1.1. *Specific objective: All AIFM are subject to appropriate authorisation and registration requirements*

Sub-threshold AIFMs

One of the main objectives of the AIFMD is to monitor and mitigate macro and micro risks that stem from the activities of AIFMs.[124] In practical terms, this requires identification of the relevant entities, which should meet the basic requirements enabling them to professionally and responsibly manage collective investments for the benefit of investors. The EU legislation sets thresholds for assets under management (AuM) above which the activities of AIFMs may pose significant systemic risk and impose additional requirements on those AIFMs. The thresholds differ depending on whether the AIFs employ leverage or not.

According to the AIFMD, AIFMs that manage portfolios of AIFs exceeding € 100 million of AuM and that use leverage shall be authorised by the NCA of its home Member State and must comply with all the requirements of the AIFMD.[125] For the AIFMs that do not use leverage, the threshold is raised to € 500 million and includes the requirement to not have redemption rights exercisable during a period of 5 years following the date of initial investment in each AIF.[126]

Member States must ensure that AIFMs managing AIFs beneath the thresholds, instead of being fully licenced under the Directive, are at least registered with the NCA and report on their principle exposures and most important concentrations for the purposes of system risk monitoring. Member States have a wide discretion on whether to impose stricter requirements[127] on smaller fund managers, which makes isolated assessment of the impact of the AIFMD threshold provisions difficult. A number of Member States chose to adopt stricter rules for the sub-threshold AIFMs in some cases simply continuing to apply national rules that had been in place before the AIFMD adoption.[128]

One-quarter of all respondents to the KPMG Survey considered that there is no significant differentiation in the national laws governing smaller and larger AIFMs, despite such a possibility being provided for in the AIFMD.[129] Academic literature similarly questions the of the registration regime, as elaborated in the AIFMR[130], where supervisory reporting requirements are for the most part the same for all AIFMs regardless of the size of their activities.[131]

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[124] Recital 2 of the AIFMD.
[125] Article 3(2)(a) of the AIFMD
[126] Article 3(2)(b) of the AIFMD
[127] Article 3(3) of the AIFMD.
[128] KPMG Report, pp. 134-138 examining regulation in MT, IRL, DE, FR, NL, UK, LUX.
[129] KPMG Report, p. 134
[130] Articles 5 and 110 of the AIFMR.
[131] Dirk Zetzsche, The Alternative Investment Fund Managers Directive, Second Edition, Kluwer Law International, 2015, p. 81.

The AIFMD provides for national discretion to maintain lighter rules for smaller AIFMs and this is deemed to be in line with the principle of proportionality.[132] It is true, however, that some Member States choose to apply the AIFMD in its entirety regardless of the volume of the assets managed by the AIFM. This would call into question the effectiveness and proportionality of the thresholds. In particular, it is considered burdensome for smaller AIFMs to comply with the regulatory reporting requirements (although with a lesser frequency) to the same extent as the larger AIFMs (this is discussed further in section 5.1.2. on reporting requirements). Nevertheless, some discretion in this respect exists within the AIFMD and may be implemented by the Member States.

The problem is more acute with regard to smaller AIFMs that would like to operate across the Union but find it too burdensome to comply with all the requirements of the AIFMD. Some Member States restrict the activities of sub-threshold AIFMs, unless they opt into a full application of the AIFMD, which prevents such funds from enjoying the benefits of the internal market and there some respondents called for greater harmonisation of the rules for smaller AIFMs.[133]

4.1.2. Specific objective: Proper monitoring of macro-prudential risks

Loan originating AIFs

In the EU, the non-bank financial sector has already reached the same size as the banking sector in terms of financial assets – a growth trend that is expected to continue. Further progress towards the Capital Markets Union will further strengthen the role of market-based finance in Europe and lead to a more diversified financial system. One element of the expanding non-bank financial sector is attributed to the soaring private credit market - around 50% of business debt financing in Europe is provided by non-bank lenders and bond investors. ESMA and NCAs have observed the continued expansion of private equity funds, which are active in extending loans.

The retreat of the banking sector and growth of non-bank lending financing is one of the biggest and most significant trends in the European economy and financial system during the last decade. A larger share of financial intermediation occurring outside the banking sector can be helpful in absorbing initial shocks and smoothing the flow of credit to the real economy while achieving greater (cross-border) risk diversification, it can also give rise to the emergence of new systemic risks.

At present, there are no common rules for loan originating AIFs with AIFMs managing these funds subject to varying national rules. This presents a challenge in preserving a level playing field and monitoring the stability of the financial system. In this respect, the use of leverage by such funds and their inter-linkages with credit institutions may require a policy response.[134]

In its letter of 18 August 2020,[135] ESMA already expressed the belief that there should be a specific framework for loan origination within the AIFMD. On this topic, ESMA already

[132] KPMG Report, p. 149. EGESC meeting of 27.09.2019.
[133] Ibid., pp. 101 and 142. EGESC meeting of 27.09.2019
[134] ESMA issued an opinion on the matter in 2016.
[135] https://www.esma.europa.eu/sites/default/files/library/esma34-32-551_esma_letter_on_aifmd_review.pdf

issued an opinion on key principles for a European framework on loan origination by funds in April 2016.[136] The ESMA opinion contains recommendations on authorisation for loan originating funds, types of funds (closed-ended vehicles), admitted investors (complying with ELTIF rules), and organisational and prudential requirements for loan-originating funds (e.g. leverage, liquidity, stress testing, reporting, diversification, etc.).

Supervisory reporting requirements

Prior to implementation of the AIFMD, NCAs pursued different measures on Member State level, which provided a certain degree of transparency of domestic collective investment management activities as well as the monitoring of macro-prudential risks. The responsibility for implementation and application of such measures rested with the NCAs at domestic level, which resulted in different types and scales of mechanisms throughout the EU.

A key objective of AIFMD was to increase the transparency of AIFMs and AIFs for investors, NCAs and other official bodies. In the light of the experiences of the financial crisis and increased recognition of the range of risks to which AIF investors and markets were exposed, there was a clear need to devise an effective mechanism to share, pool and analyse information at the European level enabling to effectively monitor the AIF market and the aggregate risk transmission channels in the broader financial system. Consequently, AIFMD introduced safeguards to ensure that, in addition to enhanced disclosures to investors, NCAs and ESMA are provided with sufficient information in order to monitor systemic risks at national and EU level.

The AIFMD imposes supervisory reporting obligations on the AIFMs, regardless of their place of establishment, as opposed to their managed AIFs. The recipients of the information are NCAs. Once the data is reported, the NCA of the home Member State of the AIFM must ensure that it is made available to the NCAs of other relevant Member States, ESMA and the ESRB.[137]

The AIFMD reporting framework consists of 69 reporting obligations, which equates to a total of 517 data points to be reported.[138] The legal reporting obligations for registered and authorised AIFMs cover the main instruments in which their managed AIFs are trading, principle exposures and the most important investment concentrations of the AIFs.[139] A fullscope AIFM must moreover report a breakdown of its investment strategies, the concentration of investors and the principal markets in which the respective AIFs trade as well as risk profiles of individual AIFs, including market risk, counterparty risk, liquidity and operational risk profiles, stress test results and other risk aspects such as the leverage values of the AIFs.[140]

Generally speaking, AIFMs report the required data to their respective NCAs, on both the AIFM itself and the AIFs it manages.[141] Thus, part of the legislative purpose is effectively

[136] See the opinion issued on 11 April 2016 (ESMA/2016/596), available at: https://www.esma.europa.eu/sites/default/files/library/2016-596_opinion_on_loan_origination.pdf.
[137] Point (3) of Article 25 of the AIFMD.
[138] Fitness Check Report FC: SWD(2019) 403 final. The number of reporting obligations and data points are based on analysis provided by an external contractor BRAG.
[139] Article 3(3)(d) and Article 24(1) of the AIFMD.
[140] Point (2) of Article 24 of the AIFMD.
[141] Page 153 KPMG report.

fulfilled: the harmonised requirements on reporting have increased, to at least some extent, the transparency of AIFM and AIF activities to NCAs. However, already before the AIFMD many NCAs required AIFMs to report data similar to that in the AIFMD reports. In isolation, the improvement in transparency to NCAs brought by the AIFMD is therefore limited. In assessing the effectiveness of this measure, therefore, the more pertinent questions are whether the data are appropriate, systematically analysed by NCAs, and shared and analysed at EU level, and whether those analyses are publically available to inform the market.

The results of the KPMG Survey and evidence-based study indicate problems concerning data coverage. Some respondents doubted that all the submitted data is relevant, while others, mostly NCAs, thought reported data may be insufficient.[142] Interviewed NCAs stated that they would like to receive more information on liquidity and leverage, for example, results of liquidity stress tests carried on the basis of common methodology, taking into account capital requirements and more data on leverage.[143] Data relating to loan origination was mentioned as desirable by some NCAs.[144] ESMA opined that reporting information on the Value at Risk (VaR) of AIFs should be particularly relevant for AIFs pursuing hedge fund strategies.[145] It further suggests complementing current reporting to NCAs with the information concerning:

- ‘the portfolio’s sensitivity to a change in foreign exchange rates or commodity prices; the total number of transactions carried out using a high frequency algorithmic trading technique, as defined in MiFID II, together with the corresponding market value of buys and sells in the base currency of the AIF over the reporting period;

- the geographical focus expressed as a percentage of the total value of AuM, so “that the impact of financial derivative instruments is better taken into account”; and

- the extent of hedging through long/short positions by an AIFM/AIF expressed as a percentage;’[146]

- data on non-EU master AIFs that are not marketed into the EU, but which have an EU feeder AIF or a non-EU feeder marketed into the EU if managed by the same AIFM.[147]

In fact, the Financial Stability Board (FSB) observes that the markets for leveraged loans and collateralised loan obligations (CLOs) have grown significantly in the US and to a lesser extent in the EU in recent years.[148] According to its analysis, in 2014 the issuance of CLO exceeded pre-crisis levels and continues to grow.[149] According to the supervisory and market data analysed by the FSB, while banks and insurance companies have the largest direct exposures to leveraged loans and CLOs, some open-ended investment funds hold such instruments and their liquidity could be affected in times of stress. The information on indirect linkages between banks and non-banks is missing making it difficult to appraise

[142] KPMG Report, p. 155.
[143] Ibid.
[144] Ibid., p. 83.
[145] Ibid., p. 155.
[146] Ibid.
[147] Ibid., pp. 155-156.
[148] The role of non-bank financial institutions in the leveraged loan and CLO markets has increased. See Financial Stability Board, Vulnerabilities associated with leveraged loans and collateralised loan obligations (CLOs), PLEN/2019/91-REV, 22 November 2019.
[149] Ibid.

systemic implications of the existing interconnectedness.[150] FSB suggests that data gaps should be closed by collecting the necessary information in relation to leveraged loans and CLO.

In addition, there were suggestions to make the use of a legal entity identifier (LEI) for AIF or AIFMs mandatory.[151] This would permit better matching and merging of the AIFMR data with the data reported under European Market Infrastructure Regulation (EMIR), Securities Financing Transactions Regulation (SFTR) or other Union legislation and leading to better data analysis.

Furthermore, results of the General Survey point to an inconsistent understanding of what must be reported. This concern was voiced both by the NCAs and the industry. Despite the fact that key reporting obligations are laid down at EU level and ESMA has issued Guidelines driving further convergence among the national reporting systems,[152] it remains within the national discretion to stipulate the method of data delivery and the provision of additional information on a periodic or an ad hoc basis. This leads to differences in the national interpretation and filing procedures, which were considered by the respondents as increasing costs of reporting even further.

The lack of a uniform approach at national level was also recognised during the Fitness Check. It is noted that several Member States impose additional reporting obligations at national level that are more granular than those foreseen under the AIFMD (this includes metrics concerning the funds' portfolio composition in terms of financial instrument, geographical focus, investment strategy or risk profile of the fund as a whole).

The Fitness Check also revealed that a number of supervisors consider the definitions for individual fields are too broad leaving too much discretion to AIFMs in terms of underlying methodology and assumptions. This also results in limited consistency across the same fields reported by AIFMs. Concrete examples include concepts such as 'AuM' and 'reported gross/commitment leverage calculations'.

Hence, the AIFMD reporting requirements are assessed as effective only to a certain degree as regards the appropriateness of the data.

The KPMG study also identified concerns regarding the "one size fits all" approach to supervisory reporting claiming that it fails to fully reflect the different nature of the underlying funds. It has also questioned whether the proportionality principle is respected when small firms engaged in less risky strategies are subject to detailed reporting requirements.[153] Similarly, in the context of the Fitness Check, some stakeholders complained that the current reporting framework is not adequately tailored considering the differences in the operations and associated risks of different AIFs. Suggesting that not all reporting fields are always relevant (e.g. market risk indicators, stress tests) a proposal was made to refocus the requirements to tailor them to each investment strategy.

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[150] Ibid. Also see ESRB recommendation.
[151] KPMG Report, p. 84. See supra 9 ESRB recommendation.
[152] ESMA Guidelines on reporting obligations under Articles 3(3)(d) and 24(1), (2) and (4) of 8.08.2014 ESMA/2014/869E.
[153] Supra 108, pp. 413 - 414.

The respondents to the General Survey agree that the initial investment in implementing the necessary internal structures to fulfil reporting obligations was substantial and any changes proposed should be assessed being conscious of the significant sunk costs. Given the results of the KPMG study and the Fitness Check, it is apparent that further improvements to the reporting framework under the AIFMD are possible.

Finally, bottlenecks exist for ESMA to receive all the reporting data from NCAs even though improvements in this respect are continuous.[154] At the same time, the respondents to the General Survey indicated that they would appreciate information on how the collected data is used.[155] Whilst the regular reports on the national AIF/AIFM markets remain scarce, 60% of the respondent NCAs confirmed they produce regular analysis to monitor market trends.[156] Moreover, the accumulated databases allow identifying and interrogating outliers.[157] In 2017 ESMA published the first statistical report on the EU AIF market and aims to issue one every year. Increased publicity of conclusion drawn up by supervisors based on the collected data would also leave the markets better informed.[158]

The AIFMD introduced for the first time an EU-wide approach to supervisory reporting in the context of AIFs. Despite the fact that the reporting obligation proved successful by providing the NCAs with the significant volumes of data to monitor systemic risks, certain areas were identified as requiring further clarification and cooperation among the supervisory authorities. Member States were also broadly in agreement that the AIFMD reporting obligations should be streamlined.[159]

The relevant discussion in international fora will influence this area. The following section refers to the IOSCO work on leverage calculation. IOSCO proposes jurisdictions to collect national/regional aggregated GNE or GNE adjusted data, broken down by asset class and long and short exposures, as well as NAV, on a yearly basis, as a solution to monitor leverage trends overtime.[160][161] The focus on the format of the reported data is likely to influence the current reporting template of the AIFMR.

There are views that the AIFMD supervisory reporting data should be reported centrally, for example to ESMA, which would validate it and store it in a fashion similar to its handling of the daily transactions reporting data under MiFID II. The authorised entities then could access the central database in accordance with their mandates. This could reduce administrative costs for the NCAs and industry alike and ensure that authorities with financial stability mandates access all the relevant data.

[154] KPMG Report, pp. 156 and 157.
[155] Ibid., p 85.
[156] Ibid.
[157] Ibid.
[158] Ibid., p. 156.
[159] EGESC meeting of 27.09.2019.
[160] IOSCO recommends regulators to collect GNE or adjusted GNE broken down by asset classes, and long and short exposures. Gross Notional Exposure (GNE), which is the sum of all the absolute value of all positions / NAV, is very similar to the "gross method" under the AIFMR. GNE adjusted, which implies adjusting GNE with regards to some derivative positions (e.g. adjustment of interest rate derivatives positions by 10-year bond duration), is very similar to the methodology used for private funds in the US.
[161] The data collection will likely be conducted by IOSCO in a phased-in manner as it will take one to four years for some jurisdictions to make legislative changes to collect the relevant data.

Moreover, it may be worthwhile considering whether for macro-prudential reasons it may be more useful for the supervisors to receive a full portfolio holdings of the AIFs or at least with respect to a particular asset class, such as for example CLO or leveraged loans, in order to get a better overview of the market. In the meantime, ESMA is continuing to provide technical clarifications on the supervisory reporting requirements in order to achieve greater uniformity across the Union.[162]

Leverage calculation methodologies under AIFMR

Leverage is considered one of the key risks and vulnerabilities related to asset management activities.[163] It is used as a technique, often through the use of derivatives, to increase returns through borrowing of assets, including cash or securities. Excessive use of leverage, however, amplifies potential losses in case of negative shocks, thereby reducing the resilience of market participants.

The AIFMD provisions on the monitoring of systemic risks[164] include the calculation of leverage and the reporting of the leverage levels to the NCAs. Leverage-related data are monitored and shared among the national regulators and ESMA.[165] More specifically, the AIFMR requires leverage to be calculated in accordance with two methods: (i) 'the gross method', which is the sum of the absolute values of all positions, so as to give an indication of overall exposure and (ii) 'the commitment method', which is the sum of the absolute values of all positions, adjusted for various factors, including the application of netting and hedging arrangements.[166]

A representative majority of the asset management industry and the NCAs regard the leverage provisions under the AIFMD as appropriate and effective.[167] In particular, 90% of NCA interviewees to the KPMG survey recognised that AIFMs could contribute to the build-up of systemic risks or disorderly markets if use of leverage is high, but most NCAs that responded to the survey did not express any concerns about the leverage levels they observe in AIFs in their jurisdictions.[168] Moreover, the methodologies under the AIFMR are deemed to be comprehensive and advanced in comparison to the other existing measures of leverage thereby encouraging harmonization towards these methodologies at global level.[169]

The combination of gross and commitment methods to measure leverage under the AIFMR, albeit initially criticised as being too burdensome, provides a clear leverage exposure at the level of an individual AIF. There are different challenges in calculating leverage across a wide range of portfolios with different investment strategies and different risks in relation to their underlying assets. No unique single measure can capture all the risks and give a representation of the potential economic over-exposure of investment funds and every measure of leverage has some drawbacks. This is also true for the AIFMR methodologies.

[162] ESMA Work stream on the data reporting.
[163] FSB Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities, 12 January 2017; IOSCO Final Report on Recommendations for Liquidity Risk Management for Collective Investment Schemes of February 2018, FR01/2018.
[164] Recital 3 of the AIFMD.
[165] Article 25 of the AIFMD.
[166] Section 2 of Chapter II of the AIFMR.
[167] KPMG Report, pp. 171-172.
[168] KPMG Report, p. 171.
[169] Ibid.

Admittedly, there are limitations in the AIFMR commitment approach linked to the complexity of its netting rules, which can imply a certain lack of clarity and a certain degree of subjectivity on the measuring of hedges or offsetting positions. There are opinions that the prescribed methods do not align with industry practice in some sectors (closed-ended funds, private equity funds) and lack the necessary metrics to provide accurate reflection of the risks associated with the use of leverage. Nevertheless, the leverage calculation methods set forth by the AIFMR are considered sufficiently sophisticated. Any changes thereto should improve comparability of data reported and leverage calculations. Necessarily this would require taking into account developments at international level, notably the IOSCO policy work regarding measures of leverage in investment funds.[170]

Considering the difficulties in coming up with a "consistent" measure of leverage that could be aggregated across funds and jurisdictions,[171] IOSCO recommends adopting a leverage framework based on a two-step approach. As a step 1, based on a gross measure of leverage, one would filter and identify those funds that may pose risks for financial stability and deserve further risk analysis.[172] In step 2, a list of indicators and complementary risk-based measures are provided by IOSCO for NCAs consideration to assess potential risks posed by funds identified under step 1. This would leave each jurisdiction free to fine-tune the reporting requirements and risk-based leverage methodologies further depending on the size and complexity of their markets.

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One of the main objectives of AIFMD was to increase the transparency of AIFMs vis-à-vis investors and competent authorities. Because of the experiences from the financial crisis and the range of risks to which investors in investment funds were exposed, the provisions of AIFMD introduced safeguards to ensure that not only investors in alternative investment funds but, most importantly, the relevant NCAs were provided with sufficient information in order to monitor systemic risks within the EU.

Prior to implementation of AIFMD, NCAs pursued different measures on Member State level so as to provide a certain degree of transparency of collective investment management activities, as well as the monitoring of macro-prudential risk exposures. The AIFMD Impact Assessment notes that the responsibility for implementation and application of such measures rested with the NCAs on domestic regulatory level, which led to different types of mechanisms throughout the EU/EEA.

AIFMD led to a harmonised approach to the calculation of leverage, to the processes and systems AIFMs must have in place to ensure that the leverage limits for each AIF they manage are reasonable and are complied with at all times, and to the reporting of leverage levels to the NCAs. Moreover, according to ESMA, all NCAs have implemented the ESMA AIFMD Reporting Guidelines concerning leverage. As a consequence, systemic risks can be

[170] Seconded by Member States at the EGESC meeting of 27.09.2019.
[171] Due to the differences in reporting requirements across jurisdictions, market structures, funds' strategies.
[172] IOSCO proposes to use metrics based on gross exposure under step 1: Gross Notional Exposure without adjustments or the Gross Notional Exposure adjusted for interest rate derivatives and options. IOSCO indicates that jurisdiction can use an additional/complementary measure to GNE or GNE adjusted by taking into account potential netting and hedging arrangements or relationships in the fund's gross exposure.

monitored in a harmonised manner at domestic level by the NCAs and at EU level by ESMA. NCAs are able to monitor if an AIFM manages AIFs that could potentially constitute an important source of counterparty risk to a credit institution or other systemically relevant institution in other Member States or to investors.

Thus, the legislative purpose is effectively fulfilled as transparency of AIFM and AIF activities have increased.

It is noted, though, that both the reporting of leverage ratios and the demonstration by the AIFM that its leverage limits are reasonable and that it complies with those limits at all times are submitted only to the relevant NCA. Unlike the publicly available prospectuses for UCITS, the information documents of AIFs, which describe inter alia the maximum level of leverage and the use of derivative trades incurring leverage, may not be accessible to non-investors.

As a consequence, it is possible that counterparties trading with an AIFM or AIF may not be immediately or fully aware of the possible leverage risk and possible changes of any predetermined and disclosed leverage ratios of the relevant AIFs.[173] Further, measurements taken by the relevant NCA against a particular AIFM/AIF, which were necessary to avoid risks to the stability and integrity of the financial system, may not be publicly disclosed. Therefore, potential counterparties of an AIFM/AIF may not be aware of any measurements imposed by the NCAs. Consequently, if the counterparty does not perform proper due diligence and require specific disclosures, it could subject itself to unidentified risks. This detracts from effectively achieving the objective of transparency.

4.1.3. Specific objective: Proper monitoring and limitation of microprudential risks

Delegation rules

A core element of the AIFMD governance, risk and investor protection requirements are the provisions relating to delegation. An AIFM is able to delegate the carrying out of certain (management) functions[174] on its behalf only when limitations and a range of strict requirements are met, so as to further increase the efficiency of the conduct of the AIFM's business.[175] At all times, the AIFM remains fully responsible and liable to the AIF's investors for the provision of management functions.

Delegation is a tool used by fund managers for various reasons including optimising business processes, seeking specific expertise or to sometimes exploiting regulatory arbitrage opportunities.[176] With particular regard to the latter, the EU legislature has sought to avoid creating conditions for a race to the bottom with other jurisdictions in terms of regulatory standards.[177] Therefore, whilst the AIFMD permits AIFMs to delegate to third parties

[173] Raised issue for the German market, cf. Decker, in Frankfurter Kommentar, KAGB (Frankfurt Legal Commentary for the German transformation Act of AIFMD), § 274, margin no. 8.
[174] Supporting functions (i.e. administrative and/or technical activities) are not subject to the strict delegation requirements of AIFMD, see Recital 31.
[175] 231 Recital 30 AIFMD. Those requirements are also valid vis-à-vis sub-delegation.
[176] Eddy Wymeersch, Brexit and the Provision of Financial services into the EU and into the UK, ECFR 4/2018, p. 738.
[177] ESMA Statistical Report, p.269.

portfolio management or risk management, it also contains a number of safeguards subject to supervisory assessment.

The AIFMD and the AIFMR lay down detailed requirements for the delegate and obligations of the delegating AIFM as well as its remaining liability towards the managed AIF and investors.[178] The core functions of AIFMs can be delegated only to undertakings registered or authorised for asset management and supervised by the competent authorities.[179] The delegate must be of good repute, qualified, have sufficient technical and human resources, and possess expertise necessary to discharge vested tasks.[180] Moreover, the AIFM must supervise the delegate and be able to withdraw delegation immediately.[181] Importantly, AIFMs cannot delegate the core functions to depositories or any entity, whose interest may conflict with those of the AIFM or the AIF's investors.

NCAs must be notified before the delegation arrangements become effective so they can assess whether the delegation structure is objectively necessary. These most commonly include optimisation of business functions and costs, seeking expertise of the delegate in specific markets or accessing global trading capabilities.[182] Where a delegate is a third country undertaking, a cooperation agreement between the relevant NCAs must be in place.[183]

AIFMs can no longer be considered as such if they turn into letter-box entities. An entity is no longer considered to be an AIFM where it does not ensure a permanent supervision of the delegate or does not retain the prescribed standard of decision making. As a consequence, the licence of such an AIFM should be rescinded.

Some stakeholders call for more harmonised rules on delegation.[184] The effectiveness of the rules on delegation is bound to rest entirely on their diligent enforcement by the supervisory authorities. AIFMs, which appear to host 'empty shells' (engaging in so-called white label business) and delegate all investment management functions abroad, should be properly scrutinized.[185]

The majority of the respondents to the KPMG Survey did not report any material change with respect to their delegation arrangements following the application of the AIFMD.[186] 55% of respondent AIFMs delegated fund accounting, valuation and pricing functions to other entities. A slightly lower ratio of 52% also delegated other fund administration activities, followed by portfolio management activities (35%), marketing functions (29%) and risk management (10%). Smaller AIFMs were more likely than larger AIFMs to record that they delegate portfolio management. [187] In France and Luxembourg more than half of all AIFMs delegate portfolio management.[188]

[178] Article 20(3) of the AIFMD.
[179] Article 20(1)(c) of the AIFMD, Article 78 of the AIFMR.
[180] Article 20(1)(b) and (f) of the AIFMD, Article 77 of the AIFMR.
[181] Article 20(1)(f) of the AIFMD, Article 75(f) of the AIFMR.
[182] This list is not exhaustive. Article 20(1)(a) of the AIFMD and Article 76 of the AIFMR.
[183] Article 20(1)(d) of the AIFMD.
[184] EGESC meeting of 29.09.2019.
[185] ESMA opinion to support supervisory convergence in the area of investment management in the context of the United Kingdom withdrawing from the European Union, ESMA34-45-344, 13.07.2017.
[186] KPMG Report, p. 178.
[187] "Investment management functions" are defined in AIFMD to include both portfolio and risk management, so it is expected that the AIFM would retain one of these functions to ensure it meets this requirement. See the

The KPMG survey results indicate that the AIFMD delegation requirements are effective in applying appropriate governance and risk management obligations on AIFMs without adversely impacting their ability to delegate key functions to specialists (e.g. as regards asset classes, geographies or investment strategies; or as regards fund administration and fund accounting), thereby limiting and managing key operational risks for AIFs and AIF investors.

Risk and liquidity management rules

Based on the objectives of adequate risk and liquidity management controls and limitation of micro-prudential risks, the AIFMD aims to control the most important risks faced by AIFMs and AIFs (market, liquidity, counterparty and operational risks). AIFMs are therefore required to establish appropriate controls and processes.[189]

Almost all of AIFM respondents to the KPMG Survey agreed that AIFMs must have appropriate risk management policies and procedures in place.[190] There was broad agreement that functional and hierarchical separation of the risk management function sets a robust framework and corresponds to the heterogeneous universe of AIFs.[191] A bit less than a half of the respondent AIFMs changed their risk management policies and 20% their liquidity management policies since the AIFMD's coming into force.[192]

The majority of AIFMD interviewees in nearly all the Member States noted that implementation of AIFMD had resulted in only minor changes in substance to risk management processes, because national rules already existed or because they drew on their experience with UCITS requirements (to which a majority of the interviewees were already subject).[193] Changes were said to have been made primarily in the area of calculating leverage and articulating internal governance processes.[194]

However, for some AIFMs the AIFMD requirements had had a greater impact in some sectors of the AIF universe. This was in particular the case for AIFMs managing real estate or private equity funds, as they have traditionally performed risk management as a part of the portfolio management function.[195] Whilst hedge fund managers found requiring separation between risk management and portfolio management to be sensible, private equity managers took the opposite view as regards their sector and referred to the increased costs.[196]

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paper "Delegation of Investment Management under the AIFMD", Mark Browne, Partner at Mason, Hayes & Curran

[188] KPMG Report, p. 178.

[189] Cf. for further details Deloitte, Risk management within AIFMD for private equity and real estate funds (2014).; PwC, Risk management, AIFMD Newsbrief: A closer look at the Impact of AIFMD on Risk and Liquidity Management (2013), p. 1 et seq.

[190] KPMG Report, p. 89.

[191] Ibid., p. 195.

[192] Ibid., p. 90.

[193] Ibid., p. 194.

[194] Ibid.

[195] Kai Braun and Désirée Springmann, Risk management under the AIFMD, 2013 December, [https://www.ipe.com/investment/briefing-investment/risk-management-under-theaifmd/www.ipe.com/investment/briefing-investment/risk-management-under-the-aifmd/10000541.fullarticle]; Risk Management for Private Equity AIFMD and SIF law – A new challenge, PWC, [https://www.pwc.lu/en/risk-management/docs/pwc-risk-management-for-pe.pdf].

[196] KPMG Report, p. 198.

Moreover, the latter stakeholders did not consider liquidity management requirements to be necessary for them.[197]

Some in the industry[198] opined that a uniform/harmonised set of liquidity tools should be available in all the Member States. There was a view that smaller fund managers may lack resources, in particular at the early stages of business, to implement hierarchical and functional separation of the mentioned responsibilities.

Analysis indicates that risk and liquidity management rules laid down in the AIFMD for monitoring micro-prudential risks are perceived as necessary and they are judged to be effective.[199] There is testimony that implementing liquidity risk management requirements helped the industry to weather several significant market dislocations.[200] As regards the smaller AIFMs, in particular those at the early stages of their activities, one must recall that the risk management provisions of the AIFMD do not apply until the AuM reach the set thresholds, which are judged to be appropriate.

The AIFMD provisions created a uniform standard in AIFMs risk and liquidity management. This enables NCAs to assess whether AIFMs have appropriate risk management controls and manage major risks. They also provide assurance for investors that the liquidity profile of an AIF is aligned with their redemption rights.

As regards the availability of liquidity tools in a harmonised way across the internal market, this has been also recommended by the ESRB[201] as well as the FSB[202] and some in the industry.[203] The ESRB observes that the availability of liquidity management tools varies substantially across Member States, whereas it contends that 'the continued growth of the investment fund sector, combined with an increase in its liquidity transformation activity, could lead to increased financial stability risks that need to be addressed.'[204]

The ESRB recommends the Commission (i) to consider including additional liquidity management tools in the constitutional documents or other pre-contractual information of AIFs (as a minimum the power to suspend redemptions should be included), (ii) provide investors with sufficient transparency in relation to such tools, (iii) ensure that the necessary operational capacity and contingency planning is available for the timely activation of such additional liquidity management tools, and (iv) report to the NCAs on the implementation and use of such additional liquidity management tools in stressed market circumstances. Most of the Member States accept the use of various liquidity management tools.

[197] Ibid., p. 90.
[198] AMIC and EFAMA.
[199] KPMG Report, p. 196.
[200] Ibid., p. 197, AMIC/EFAMA, Managing fund liquidity risk in Europe –an AMIC/EFAMA report, April 2016, p. 5.
[201] Recommendation of the European Systemic Risk Board of 7 December 2017 on liquidity and leverage risks in investment funds ESRB/2017/6, 2018/C 151/01.
[202] FSB Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities, 12 January 2017. The FSB, in its final recommendations, has also encouraged authorities to review their frameworks and consider broadening the range of additional liquidity tools available to managers.

[203] Responses to the ESMA public consultation on the draft Guidelines on liquidity stress testing in UCITS and AIFs.
[204] Recommendation of the European Systemic Risk Board of 7 December 2017 on liquidity and leverage risks in investment funds ESRB/2017/6, 2018/C 151/01, Annex II, C 151/17.

While liquidity management tools remain primarily the responsibility of the fund manager, the ESRB highlights that there could be situations in which fund managers may be reluctant to suspend redemptions to avoid reputational costs and competitive disadvantages. There could also be situations where a lack of clearly assigned responsibilities for NCAs might lead to insufficient reactions during stressed market conditions. The ESRB specifically recommends that the Commission proposes changes to the Union legislation to clarify the NCAs' respective roles and cooperation between them when using their powers to suspend redemptions in situations where there are cross-border financial stability implications.[205]

The ESRB also recommends that the European Commission should oblige NCAs to notify other relevant NCAs, ESMA and the ESRB thereof, prior to the exercise of the mentioned powers. Furthermore, the ESRB recommends setting out ESMA's general facilitation, advisory and coordination role in relation to the NCAs' powers to suspend redemptions in such situations, which could facilitate a more harmonised approach. The ESRB explains that there could be situations where fund managers face incentives to not suspend redemptions for reputational cost and competitive pressure and situations where a lack of clearly assigned possibilities for NCAs might lead to insufficient reactions during stressed market conditions. Meanwhile, a more active involvement of the NCAs risks creating moral hazard behaviour by the fund managers. Therefore, full implications thereof should be carefully considered.

The ESRB is also concerned that excessive liquidity mismatches in open-ended AIFs, could contribute to the build-up of systemic risks, as the forced sale of even a small amount of less liquid assets may rapidly lead to substantial amplifications of market falls. Therefore, the ESRB recommends the European Commission to mandate ESMA to prepare and update, based on ESMA’s own analysis, a list of inherently less liquid assets. As far as investment in less liquid assets by open-ended AIFs is concerned, the crucial issue is whether the portfolio composition matches the AIF’s redemption policy. In this respect, the AIFMD already requires AIFs to have redemption policies that are consistent with the liquidity profile of their investment strategy and to conduct regular stress tests under both normal and exceptional liquidity conditions.

Finally, empirical work is also necessary to determine when liquidity mismatches may be excessive. The liquidity of an asset depends on several factors (asset specific as well as market and more macroeconomic factors) and these factors can change their impact on the liquidity of an asset over time.

As regards already executed actions, recently ESMA has issued guidelines on liquidity stress testing in investment funds that brings further convergence and clarity in this area.[206] As a result, if there was a harmonised set of liquidity risk management tools available across the EU, AIFMs would be able to incorporate any of them in their AIFs’ redemption policies. The ESRB recommends to require that AIFMs of open-ended AIFs disclose internal limits, if used, to the NCAs and to report any changes to them whenever changes are applied to them and also to disclose them to investors according to guidance to be developed by ESMA.

[205] As provided in Article 46 of the AIFMD.
[206] ESMA Guidelines on liquidity stress testing in UCITS and AIFs. 2.09.2019, ESMA34-39-882. These guidelines implement one of the ESRB’s recommendations calling for greater convergence across the EU on how NCA supervise the use of this liquidity management tool.

4.1.4. Specific objective: Common approach to protect investors in AIFM managed funds

Depository regime

The global financial crisis in 2007-2009 was marked by a number of events[207] leading to irrecoverable loss of investor assets, which laid bare the necessity to strengthen investor protection. The idea of introducing a harmonised depository regime for the AIFs akin to the one contained in the UCITS framework found support among the EU decision-makers. As a result, a harmonised and robust depository regime was introduced in the AIFMD[208] requiring a third party, i.e. an appointed depository, to safe-keep AIFs' assets and oversee AIFs' compliance with national legislation and the AIF rules.

The AIFMD requires appointing, by means of a written contract, a single depositary for each AIF managed by the AIFM.[209] As a general rule, the depository is required to be established in the same Member State as the AIF.[210] Only the entities defined in the AIFMD are eligible to assume the role of a depositary[211] explicitly excluding the AIFMs of the concerned AIFs for the avoidance of insurmountable conflicts of interest.[212] This exclusion is justified given that the depository, besides asset safe-keeping, is also entrusted with a number of oversight duties, including monitoring of the AIFs' cash flows[213], in a context where AIFs are regulated at national level, as AIFMD is designed to regulate their managers.

The delegation of depository functions is limited to safe-keeping of assets and is only permitted under certain conditions, including holding of financial instruments in segregated financial instruments accounts along the custody chain.[214] The depositary, however, remains liable to the AIF or to the investors of the AIF for the loss of assets by the third party, except in case of a liability discharge or if it can prove that the loss occurred due to an external event beyond the depository's reasonable control.[215]

The majority of respondents to the General Survey agreed that depositaries provide for an appropriate level of protection for professional investors and that oversight responsibilities of the depositary cover the appropriate activities of the AIFM/AIF.[216] At the same time, some respondents communicated their challenges in ensuring compliance with the AIFMD or called for further development of the regulatory framework.

Some respondents advocated introducing a depositary passport enabling a cross-border supply of depository services.[217] In the same vein, several respondents provided positive feedback on the transitional provision, which expired on 22 July 2017 and according to which

[207] Collapse of Lehman Brothers Bank and uncovering of fraudulent asset management business of Bernard Madoff.
[208] Leading to an upgrade of the UCITS depository regime accordingly.
[209] Article 21(1) and (2) of the AIFMD.
[210] Article 21(5) of the AIFMD.
[211] Article 21(3) of the AIFMD.
[212] Article 21(4) of the AIFMD.
[213] Article 21(7) and (9) of the AIFMD.
[214] Article 21(11) of the AIFMD.
[215] Article 21(12) and (13) of the AIFMD.
[216] KPMG Report, p. 94.
[217] Ibid., pp. 95 and 207.

the relevant NCA could accept a depository being established in another Member State than the AIF.[218] This option was claimed to be of great importance for smaller markets where the choice of depositaries is very limited. Too few sub-custodians, difficulties in finding fund administrators (independent from the depositary) and uncertainties as to how to verify ownership of venture capital investments were also mentioned as practical hurdles in ensuring compliance with the AIFMD.[219]

Several respondents to the General Survey indicated challenges in relation to prime brokers. Certain views favoured imposing an obligation on the US prime brokers to report to the depositary on the AIF assets.[220] In addition, interpretation of the provisions on delegation of custody to prime brokers was claimed to vary in different Member States.[221] This may impact the effectiveness of the harmonised framework. Some respondents criticised the requirement to hold multiple omnibus accounts to ensure full compliance with the asset segregation rules. They judged the requirement laid down in Delegated Regulation 231/2013 as inefficient and burdensome. Some pointed out the differing interpretations of a Central Securities Depository's (CSD) liability in the custody chain, whereas others noted that they would have concerns if the AIFMD rules were applied to CSDs.[222]

In the framework of ongoing implementation work regarding the Delegated Regulation on safe-keeping duties of depositaries[223], questions appeared as to the application of delegation rules to tri-party collateral managers. The tri-party collateral manager is the delegate of the depositary and of the AIFM where the latter chooses to use tri-party collateral management services. The AIFMD, however, does not contain specific rules to govern such relationships.

Despite the past difficulties,[224] recital 36 of the AIFMD invites the European Commission to examine the possibility of putting forward an appropriate horizontal legislative proposal conferring a right to depositaries to provide services in another Member State. Gaps in harmonisation of national laws on securities and major differences in fund accounting rules continue to persist and for some are key obstacles for the EU depositary passport. On the other hand, the latter do not present insurmountable hurdles to the depository passport as evidenced by the cross-border activities during the transitional period. In 2018, about 10% of the depositaries had a different domicile than the fund. Given expiration of the transitional arrangements, there seems to be a compelling reason to find a solution for the smaller markets where depository service providers are very few to choose from, if any.

As regards the feedback relating to prime brokers, it should be recalled that depositaries can only delegate safekeeping of assets. The delegation of asset safe-keeping to prime brokers is limited to delegation of custody.[225] The prime broker is obliged to provide a daily statement

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[218] Ibid., pp. 203 and 208, Member State derogation based on Article 61(5) of the AIFMD.
[219] Ibid., p. 96.
[220] This seems linked to a lack of enforcement of Article 91 of AIFMR, which contains a general obligation for prime brokers to report to the depositary on the AIF assets.
[221] KPMG Report, p. 96.
[222] Ibid., pp. 96 and 113.
[223] Commission Delegated Regulation 2018/1618 of 12 July 2018 amending Delegated Regulation (EU) No 231/2013 as regards safe-keeping duties of depositaries, OJ L 271, 30.10.2018, p. 1.
[224] In the past, the Commission had brought forward twice the idea of a depositary passport, first in its proposal for a UCITS II Directive, which has never been adopted, and much later in its proposal for AIFMD, which has, due to a lack of support by co-legislators, been adopted without the relevant provision.
[225] Article 21(4)(b) of the AIFMD.

to the depositary, which includes information about the value of the assets held in custody. The depositary must ensure that the reporting flow is clearly stipulated in its delegation contract with the prime broker.

The recent amendments to the Commission Delegated Regulation 231/2013[226] allow the comingling of the depositary's clients' assets at the delegate level, while requiring that the depositary's own assets, the delegate's own assets and the delegate's other clients' assets are segregated. The amended Delegated Regulation clarifies that the depositary itself must maintain a record in the financial instruments account it has opened in the name of the AIF or in the name of the AIFM on behalf of the AIF and, therefore, cannot exclusively rely on the books and records held by the delegate.[227]

As regards the application of the AIFMD rules to CSDs, one of the guiding principles of the Union is to preserve a level playing field. This means that entities providing the same services should be subject to the same rules, except where it is imperative to account for the relevant differences. Treating a CSD as a delegate of a depository is also of practical importance. Given that depositories are subject to strict liability where delegates lose AIFs' assets they should be able to fulfil their duties and to undertake due diligence measures when assets are in the CSD's custody.

In 2017 ESMA issued an Article 34 Opinion[228] requesting changes to the depositary delegation rules in AIFMD with regard to central securities depositories (CSDs). ESMA recommends that AIFMD be clarified to allow depositaries not to apply the delegation rules to CSDs in their capacity as Issuer CSDs. Depositaries should be required to apply the delegation rules to CSDs in their capacity as Investor CSDs. Furthermore, this change should also be made in the UCITS Directive when it is reviewed.

Overall, the AIFMD regime for depositories is judged to remain valid and effective. The fundamental principle of separating investment decisions from custody of the AIFs' assets is not challenged. Rules governing delegation of custody to third parties have been clarified by the mentioned amendments to the Delegated Regulation addressing the alleged shortcomings. A number of the other discussed issues could be addressed by considering changes to the AIFMD.

4.1.5. Specific objective: Develop the single market in AIFs

Single Market for EU AIFs

a) Marketing of EU AIFs to retail investors

The marketing passport allows an EU AIFM, authorised in its home Member State, to manage an AIF in other Member States and to market units or shares of EU AIFs it manages to professional investors resident in other Member States under the freedom to provide

[226] Commission Delegated Regulation 2018/1618 of 12 July 2018 amending Delegated Regulation (EU) No 231/2013 as regards safe-keeping duties of depositaries, OJ L 271, 30.10.2018, p. 1.
[227] Ibid., Recital 4.
[228] See the opinion which is available at: https://www.esma.europa.eu/sites/default/files/library/esma34-45277_opinion_34_on_asset_segregation_and_custody_services.pdf

services or by establishing a branch.[229] Individual Member States may permit marketing of AIFs to retail investors within their own jurisdiction and impose additional conditions as they deem fit.[230]

Pursuant to Article 43(2) AIFMD Member States may impose stricter requirements on the AIFM or the AIF than the requirements applicable to the AIFs marketed to professional investors in their territory but shall not impose stricter or additional requirements on EU AIFs established in another Member State and marketed on a cross-border basis than on AIFs marketed domestically.[231]

As regards access to retail investors, the respondents to the KPMG Survey provided mixed views: 44% reported an increased investment from this investor group, 22% observed no change and 22% reported a strong decrease.[232] The cost of complying with the AIFMD and investment restrictions imposed by some Member States for AIFs targeting retail investors were cited by some as an impediment to marketing AIFs to retail investors.[233] Nevertheless, about 40% of the respondent AIFMs market their EU AIFs to EU retail or semi-professional investors.[234] The majority agreed that following implementation of the AIFMD, the ability to market non-EU AIFs to retail investors had become more restricted.[235]

The key things most often mentioned as adversely impacting retail investors were:

- higher costs (fees, valuation cost, AIFM costs, indirect cost, protection costs, regulatory costs, compliance costs, reporting costs), which had resulted in products available to retail investors being more expensive to run and support;
- small managers finding it no longer viable to be an AIFM and to comply with all the requirements;
- local private placement regimes (lack of them, non-availability for retail investors, too restrictive or too onerous).

Topics less frequently mentioned were the new MiFID II professional investor definition (potential reclassification of some high net worth individuals and municipalities as retail clients and a more restrictive approach to opting up retail clients to professional), no marketing passport and limitation on distribution. Topics mentioned occasionally were:

- that non-UCITS funds are automatically AIFs (e.g. French Fonds Commun de Placement d'Entreprise);
- the size of retail investments in AIFs is not sufficient in view of the compliance costs (i.e. the cost vs return ratio is not viable);
- guidance by ESMA that all AIFs are "complex";
- investment restrictions imposed by some countries on AIFs targeting retail investors;
- a one-size-fits-all approach to regulation.

[229] Articles 31 and 32 of the AIFMD.
[230] Article 43 of the AIFMD.
[231] As follows from the KPMG Report, Member States made extensive use of this possibility to retain an NPPR for certain types of AIFs for retail investors as stipulated under Article 43 AIFMD.
[232] KPMG Report, p. 111.
[233] Ibid.
[234] Ibid., p. 100. The category of semi-professional investors is not currently defined in the Union's acquis and the scope of it is not clear.
[235] KPMG Report, p. 102.

It was reported that the overall consequence of AIFMD has been less choice for retail investors, including for high net worth clients and semi-professional investors.

The AIFMD requirements on access to retail investors have thus not reached their full potential from an effectiveness point of view.

b) Auxiliary services provided by AIFMs
In addition to collective investment management, licenced AIFMs can seek supplementary authorisation to provide a number of auxiliary services. These include individual portfolio management of investments on a discretionary basis, investment advice, safekeeping and administration in relation to shares and units of CIU and reception and transmission of orders in relation to financial instruments.[236] Where financial instruments are involved, AIFMs are required to comply with the enumerated provisions of the MiFID.[237] Since the adoption of the AIFMD, the MiFID framework has undergone some major changes. Therefore, to ensure a level playing field between investment firms and AIFMs where they provide competing services, the AIFMD should be also aligned to cover the relevant obligations as laid down in the MiFID II.

4.2. Efficiency

The efficiency analysis compares the actual situation with the hypothetical situation of not having an AIFMD in place, in order to determine what are the costs it entails, and whether these are proportionate to the benefits it brings. However, the efficiency analysis also compares the current situation with the situation before the intervention (i.e. when there was no AIFMD in place), in order to determine whether the current rules have increased costs for stakeholders.

Besides the benefits, the AIFMD has also brought a number of costs to stakeholders.

4.2.1. Specific objective: All AIFM are subject to appropriate authorisation and registration requirements

Sub-threshold AIFMs

As regards proportionality, arguably the implementation of thresholds at EU level in general would seem appropriate when assessed against the purpose of exempting AIFMs from full authorisation. Such *de minimis* rules can be seen as a legitimate means to achieve two goals: to prevent unnecessary regulatory and administrative burdens on AIFMs and NCAs on the one hand and, on the other hand, providing for the monitoring of systemic risk stemming from (larger and potentially leveraged) AIFs/AIFMs.

The EC considered the *de minimis* rule under Article 3(2) AIFMD a necessity in view of the principle of proportionality.[238] It noted that the management of AIF portfolios with total assets of less than EUR 100 mn is "*unlikely to pose significant risks to financial stability and*

[236] Article 6(4) of the AIFMD.
[237] Article 6(6) of the AIFMD refers to the obligations of Directive 2004/39/EC.
[238] EC Explanatory Memorandum to the Proposal for a Directive if the European Parliament and of the Council on AIFMs and amending Directives 2004/39/EC and 2009/…/EC 30.4.2009 COM(2009) 207 final, 2009/0064 (COD).

market efficiency. Hence, extending these regulatory requirements to small managers would impose costs and administrative burden which would not be justified by the benefits.” Similarly, it is argued that the higher threshold of EUR 500 mn for AIFMs that only manage AIFs that are not leveraged and that do not grant investors redemption rights during a period of five years following the date of constitution of each AIF is justified by the fact that managers of unleveraged funds are not likely to cause systemic risks.[239] Although this assessment had been met by criticism with regard to the prevention or containment of systemic risk, since actions from smaller market participants – following the "herd instinct" with comparable investment strategies – may also lead to systemic risks, the conclusion that the *de minimis* rules are proportionate at least to a certain degree seems reasonable.[240]

In principle, the aims of reduced burdens as well as containment of systemic risk can be best achieved at EU level to achieve at least some kind of level playing field for market participants. It would not seem plausible that a similar outcome could be reached with regulation only at Member State level.

The fact that there has not been growth in fully licenced AIFMs in all Member States, and that the number of registered AIFMs is not insignificant, indicates that the levels of the thresholds are efficient and appropriate and would not seem to go beyond what is necessary to achieve the goals of minimising regulatory and administrative burdens and containing systemic risk. Hence, the overall assessment of the measures taken can be regarded as proportionate.

4.2.2. Specific objective: Proper monitoring of macro-prudential risks

Loan originating AIFs

Since there are no common rules for loan originating AIFs at present, it is not possible to evaluate efficiency from a backward-looking perspective.

Supervisory reporting requirements

The respondents to the KPMG Survey agree that the initial investment in implementing the necessary internal structures to fulfil the AIFMD reporting obligations was substantial and any changes proposed should be assessed being conscious of the significant sunk costs.

Most respondents also reported that the costs and human resources expanded by AIFMs on ongoing compliance with the reporting requirements are significant components of the overall transaction and operational costs, for example because more personnel are employed to maintain the processes and sense check the reports. Also, different NCAs employ different IT arrangements and formats for receipt of the reports. Therefore, firms needing to report to more than one NCA cannot fully centralise and standardise their reporting systems.

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[239] EC Explanatory Memorandum, ibid.

[240] See Tollmann in: Dornseifer/Jesch/Klebeck/Kunschke/Machhausen, Directive 2011/61/EU, Art. 3 margin no. 19.

For a large number of AIFMs the *frequency* of reporting and the *content* of reporting has increased as a result of AIFMD.[241] Hence, it can be concluded that the costs of complying with the reporting obligations have increased.

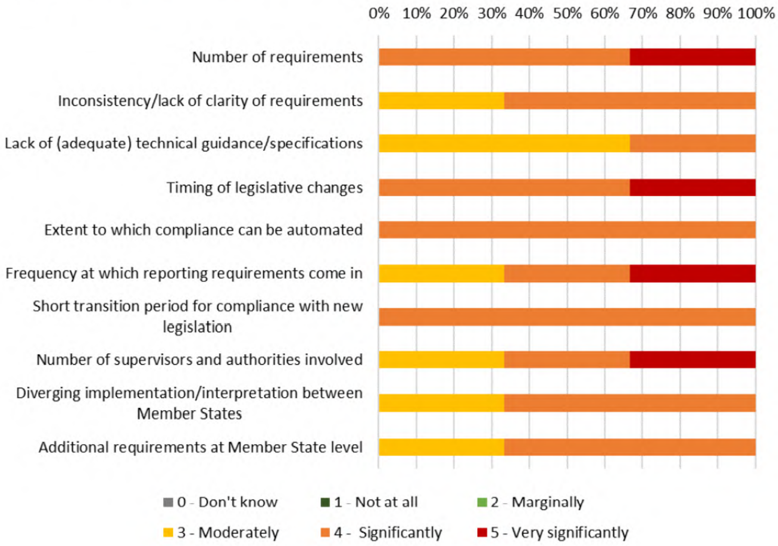
For example, regarding reporting under the AIFMD, KPMG[242] presented a survey in 2013 with evidence of the comparative compliance costs for hedge funds in different jurisdictions. It concludes that hedge funds headquartered in the Asia-Pacific region allocated a larger share of their total operating costs to compliance than their European and North American counterparts. While more than a third (37%) of Asia-Pacific respondents declared they were allocating 10% or more of operating costs to compliance, the percentage was lower for North American (26%) and European (21%) funds. As regards smaller hedge funds, which generally spend more on compliance in relative terms, North American funds on average spend 0.4% of their assets under management on compliance, more than funds in Europe (0.2%) and the Asia-Pacific region. Cost data for supervisory reporting only is not available. However, according to the survey, 46% of respondents said that the impact of 'AIFMD registration and reporting' on compliance costs was 'high', which is only slightly more than the 42% of respondents which said that the corresponding cost impact of registration and reporting to the U.S. Securities and Exchange Commission was 'high'. No updates with more recent survey data are available.

Source: Commission staff working document Fitness Check of EU Supervisory Reporting Requirements SWD (2019) 403 final.

The 2019 study on the costs of compliance for the financial sector[243] shows that supervisory reporting costs represent a high share (70%) of the total costs of complying with AIFMD. The factors reported to have significantly influenced supervisory reporting costs were:
- the number of requirements;
- the timing of legislative changes;
- the limited extent to which compliance processes can be automated; and
- a short transition period for compliance.

[241] KPMG report, p. 157
[242] https://home.kpmg/content/dam/kpmg/pdf/2013/10/the-cost-of-compliance-v2.pdf
[243] Study on the costs of compliance for the financial sector - Publications Office of the EU (europa.eu)

Figure 61. Extent to which factors affect supervisory reporting costs linked to AIFMD



There was however no indication from respondents that the costs of implementing the AIFMD requirements were unacceptable or significantly disproportionate relative to the potential impacts if systemic risks were to go undetected due to the lack of a proper reporting and monitoring system.

There are, however, certain aspects of the reporting regime that could be addressed, which would further enhance its efficiency.

The content-related data requirements at the level of the AIFM and its AIFs are administratively extensive and standardisation is necessary for comparative analysis. The templates provided by the various NCAs differ in terms of content, so EU-wide standardisation of reported data is not guaranteed in every aspect. It was noted by survey respondents and interviewees that there are idiosyncrasies in the AIFMD reporting requirements of each Member State, with many using different template layouts and different software versions of the ESMA reporting requirements (See Section X).

This has led to the industry having to take into account each country specific, which creates additional inefficiencies for cross-border participants.[244] The NCA reporting is extensively time- and resource-depleting as each AIF report requires – on a quarterly basis – numerous data to be aggregated. Some of the data fields are varied and prone to interpretation and calculation whereas others are required to be converted to a specific file format for transmission to the NCA, which validates the data and passes it on to ESMA, in some but not all cases.

[244] Cf. in addition the BaFin Annual Report 2015, p. 255 et seq which refers to the relevant reporting requirements; cf. for the Disclosure requirements in Ireland for Retail Investor AIF, Central Bank AIF Rulebook, p.62 et seq.

AIFM interviewees were of the opinion that reporting systems should be streamlined to reduce unnecessary administrative efforts and costs (see Section x). This is a strong indicator that at present the reporting regime is not fully efficient. The points summarised in the *effectiveness* sub-section about unnecessary, duplicative or insufficient data also bear on the assessment of efficiency. This issue is compounded when other EU reporting requirements are also taken into account.

In general, the interviewees shared the opinion that the differences in terms of interpretation and filing procedures further exacerbate the imposed regulatory costs which are not compensated for by the availability or provision of analysed market data.

Translation costs also matter, especially if AIFMs have a reporting obligation to NCAs located in jurisdictions other than the home Member State of the AIFM. This may be the case for groups with AIFMs or AIFs in different Member States, as they cannot centralise the reporting, even where the investment strategies are identical. Also, if the AIFM is invested in a target company located in that specific jurisdiction, for example. In such cases there can be further duplication of data reporting, over and above that already described.

As regards proportionality, the AIFMD reporting framework appears to comply with the purpose-means ratio, because the measures required do not go beyond what is necessary to achieve the aforementioned objective. The provisions of AIFMD in this regard are limited to those aspects that could not have been regulated by the individual Member States themselves and had to be regulated by the EU against the objectives of a level playing field and comparable data. However, it should be ensured that the relevant data are collected only where the NCAs and ESMA have identified a clear use for it in mitigating a particular risk (see ESMA AIFMR Advice). The discussion above and under *effectiveness* would indicate that additional costs could arise for ESMA, NCAs and AIFMs that are not in line to the core aim of the reporting requirements.

In conclusion, it can be said that because the activities of AIFMs can have effects across borders and on financial actors around them, it seems appropriate that NCAs are in the position to monitor these entities in a similar manner to their monitoring of other financial institutions. The increased transparency achieved and the information received through the provisions on reporting to NCAs under AIFMD should make it easier for regulators to detect and respond to risks in the relevant markets. AIFMD has led, to a significant degree, to the standardisation of such mechanisms, processes and systems so that systemic risks can be monitored on a harmonised level in the EU, via the reporting obligations of AIFMs.

However, achievement of the principle of efficiency could be improved by addressing: the issues discussed above around appropriateness of certain of the data specified in Annex IV AIFMR; that ESMA has not received from NCAs all reported data, so has not been able to analyse post-AIFMD market trends; and that the market does not generally have access to NCA analyses. It should also be considered that the increased costs of running an AIFM business are ultimately borne to some extent by AIF investors and that generally they are not benefitting from public information flow from the NCAs.

Leverage calculation methodologies under AIFMR

The implementation of the AIFMD will have resulted in one-off and additional costs due to additional staffing and processes. KPMG found no qualitative and/or quantitative data from which estimates can be made of the cost-benefit relationship of the AIFMD leverage provisions. However, it is noted that many AIFMs were already subject to similar national requirements.[245] Besides, the increased transparency of the leverage employed by AIFMs facilitates a better monitoring of systemic risks. Therefore, the described costs appear to be proportionate and efficient in relation to the overall achieved benefits.

As regards the principle of proportionality, arguably the variety of AIFs and their underlying assets may deem an efficient regulatory approach at EU level, by way of prescribing detailed conditions, rather difficult. Hence, the European co-legislators chose to provide principles, including reporting measures, and refrained from imposing too detailed rules, but left it to the NCAs more closely to consider leverage use and potential risks. This fulfils the condition of proportionality since the AIFMD measures do not go beyond what is necessary to create an EU framework.

4.2.3. Specific objective: Proper monitoring and limitation of microprudential risks

Delegation rules

43% of AIFMs reported that the AIFMD resulted in a fee increase for delegated activities.[246] Other than this finding there is no further evidence that quantifies the benefits of the AIFMD delegation rules versus the cost of complying with them. However, given that the AIFMD rules on delegation require AIFMs to frequently monitor the delegate and review delegation arrangements and no substantial changes in delegation activities emerged after the AIFMD came into force, the increase in costs is deemed justified.[247] The fact that there is no reported reduction in the delegation of activities implies that the cost-benefit relation is at least neutral, if not positive, which supports the conclusion that the criterion of efficiency is met by AIFMD.

Risk and liquidity management rules

Over 60% of respondents to the KPMG survey said that costs had increased due to the AIFMD risk management requirements, with about 70% reporting that the provisions require AIFMs to do things they would not otherwise do or would do more efficiently, or duplicate other requirements, or do not match the requirements of their AIF investors. [248]

In the private equity and real estate sectors, the necessity of full functional and hierarchical separation of risk and portfolio management is not regarded as efficient from a cost

[245] Note that the costs associated with the reporting of leverage to NCAs is covered under the assessment of the reporting rules and is therefore not repeated here – see sub-section above.)
[246] KPMG Report, p. 179.
[247] KPMG Report, p. 179.
[248] KPMG Report, p. 198.

perspective. In some cases attempts are therefore being made to issue letters of comfort beyond the usual contractual agreements, which in turn can lead to additional costs.

The operational objective of the rules on risk and liquidity management pursuant to Articles 15 and 16 AIFMD is to impose risk management controls on major risks to which AIFMs/AIFs are exposed, in particular market, liquidity, counterparty and operational risks.

As regards proportionality, Article 15(1) AIFMD explicitly requires that the functional separation arrangements shall be reviewed by the NCA of the home Member State of the AIFM in accordance with the principle of proportionality. It is assumed that the NCAs comply with this requirement. Survey feedback, however, was that small AIFMs do not usually have enough staff to meet the functional separation requirements, which is a barrier to entry for e.g. small venture capital fund managers for whom risk management usually is an integral part of the portfolio management function and consequently is carried out by the same team.

The operational objective of the rules on risk and liquidity management pursuant to Articles 15 and 16 AIFMD is to impose risk management controls on major risks to which AIFMs/AIFs are exposed, in particular market, liquidity, counterparty and operational risks.

Articles 15 and 16 AIFMD comply with the purpose-means ratio, because the requirements do not go beyond what is necessary to achieve the specific and operational objective. The provisions of AIFMD are limited to those aspects that could not have been regulated by the individual Member States and had to be regulated by EU requirements to ensure a level playing field. Since the primary role of the liquidity management framework is to limit the risk that the liquidity profile of the AIF's investments does not align with its underlying obligations, the ESMA AIFMR Advice states that "such an approach is consistent with the request from the Commission to specify rules that are proportionate and necessary" for specifying the general obligations placed on AIFMs by Article 16(1)-(2) AIFMD.

It can therefore be concluded that the principle of efficiency is achieved. The onus is on NCAs to ensure appropriate application of the proportionality principle.

4.2.4. *Specific objective: Common approach to protect professional investors in AIFM managed funds*

Depository regime

The majority of respondents to the KPMG Survey indicated that on average it costs EUR 500,000 to obtain a depository licence. This has not appeared to defer depositories from entering the market.[249]

4.2.5. *Specific objective: Develop the single market in AIF*

Single Market for EU AIFs

[249] Ibid., p. 147.

4.3. Relevance

To assess the relevance of the AIFMD, we need to analyse whether the objectives and tools it sets out were and are appropriate to tackle the problems that existed, the issues that are being faced now, and challenges in the near future.

At the time of the intervention, the problems were related to macro-prudential (systemic) risks, micro-prudential risks, market efficiency and integrity, investor protection, impact on market for corporate control and acquisition of control of companies by AIFMs.[250]

Looking at the objectives of the AIFMD, they can be seen as adequate responses to the problems identified at the time.

4.3.1. Specific objective: All AIFM are subject to appropriate authorisation and registration requirements

Sub-threshold AIFMs

The registration-only or sub-threshold AIFM provisions appear to remain relevant several years after implementation of AIFMD in order to ensure financial stability and to facilitate a proportional access to the financial market for smaller market participants, which remains relevant for a competitive and functional European financial market. As shown in the KPMG report, the policy rationale of introducing a *de minimis* regime for AIFMs within the EU remains valid. Although many NCAs apply additional provisions to sub-threshold AIFMs, these often relate to AIFMs of AIFs marketed to non-professional investors. Such AIFMs and AIFs cannot avail of the AIFMD passports, so it seems appropriate and proportionate that it is a matter left to national discretion. They can, however, chose to opt up to a full licence in order to gain the passports.

4.3.2. Specific objective: Proper monitoring of macro-prudential risks

Loan originating AIFs

Since there are no common rules for loan originating AIFs at present, it is not possible to evaluate relevance from a backward-looking perspective.

Supervisory reporting requirements

The FSB states that the lack of consistent and accessible data acts as a significant barrier to assessing the extent to which funds' use of leverage could contribute to global financial instability and whether existing mitigants are appropriate in addressing such financial stability risks.[251] It notes the need for improved systems for aggregating and analysing information provided to supervisory authorities.

The AIFMD reporting obligations are intended primarily to make the activities of the AIFMs more transparent in order to advance financial stability on domestic and European level. This

[250] For a more elaborate explanation of these risks, see Section 2.
[251] Retrieved from http://www.fsb.org/wp-content/uploads/FSB-Policy-Recommendations-on-AssetManagement-Structural-Vulnerabilities.pdf, p. 26.

has been materially (though not fully) achieved, including – and importantly – with regard to the use of leverage in AIFs.

The overarching goal of exposing and/or making available important data sets in connection with systemic risk at the European level continues to be the focus of attention. In order to ensure financial stability in the EU and minimise systemic risk, it remains relevant and essential that the intended sharing and aggregation of data be fully implemented. Also, it is important that the wider market, including investors, can readily access EU-wide analyses, as recently provided by ESMA.

Leverage calculation methodologies under AIFMR

The use and level of leverage in each AIF are reported by AIFMs to the NCAs. The AIFMD reporting requirements therefore make it possible for regulators to observe trends and capture outliers. This enables the NCAs and ESMA to monitor potential financial stability risks and to ensure that the leverage limits for each AIF managed by an AIFM are reasonable and complied with at all times. As such, the AIFMD provisions remain of great relevance for the stability of the European financial market.

4.3.3. Specific objective: Proper monitoring and limitation of microprudential risks

Delegation rules

Delegation of management functions and operational tasks, especially those which AIFMs are not highly specialised in, while focusing on key core competencies, remains a common business models for AIFMs around the EU.[252] Therefore, the AIFMD delegation provisions remain relevant. ESMA supports this view. Moreover, survey respondents and interviewees to the KPMG study, having questioned some selected areas of the AIFMD regime, did not raise any critical issue of the AIFMD severely impacting delegation activities of the AIFMs, i.e. both parties do not doubt the relevance and need for the general delegation provisions. This supports a conclusion that the AIFMD delegation rules are aligned with the general objective of EU market integration, along with the other objectives of consumer protection and financial stability, and are still relevant.

Risk and liquidity management rules

The ongoing relevance of risk and liquidity management regulation is confirmed by global regulatory bodies, as illustrated by recent recommendations of the FSB[253] and IOSCO.[254] Also, the AIFMD risk management provisions continue to be considered by market participants as relevant, including the hierarchical separation of risk management and portfolio management.

[252] See Figure 35 on page 93 of the KMPG Report.
[253] See http://www.fsb.org/2017/01/policy-recommendations-to-address-structural-vulnerabilities-fromasset-management-activities/.
[254] See http://www.iosco.org/news/pdf/IOSCONEWS486.pdf.

However, some respondents to the KPMG survey questioned the rationale for the full application of Articles 15 and 16 AIFMD across all sectors of the AIF industry. In particular, application by NCAs of the proportionality principle to the requirement for hierarchical separation of risk and portfolio management was seen as essential for smaller AIFMs. Also, while some questioned the application of the liquidity management rules to AIFs available only to professional investors, others expressed a contrary view.

It can therefore be concluded that the AIFMD risk and liquidity management provisions remain generally relevant. They exert a harmonised discipline in striking a balance between honouring investor redemptions in a timely and fair manner with the objective of offering investors access to higher risk premia from investing in less-liquid assets.[255] Especially in times of distortive effects of expansive monetary policies and low interest rates, resulting into a yield compression on various assets, illiquid assets will remain a target investment of investors with mid- to long-term asset allocations.

4.3.4. Specific objective: Common approach to protect professional investors in AIFM managed funds

Depository regime

The AIFMD depositary rules form a substantial part of the Directive's investor protection objective. The fact that the majority of respondents to the General Survey agreed on the depositaries' essential role across all types of AIFs as providers of an appropriate level of investor protection indicates continued relevance of the provisions.

In particular, the rules provide significant guidance and clarity in relation to a range of issues relating to the duties, role and liability of the depositary. This is of relevance not only to entities intending to provide depositary services, but also to AIF investors, AIFs, AIFMs and other service providers or counterparties to AIFs.

In November 2015, IOSCO issued recommended standards on custody of CIU assets,[256] which remain current and underline the global policy-makers' view of the importance and ongoing relevance of such regulation.

4.3.5. Specific objective: Develop the single market in AIF

Single Market for EU AIFs

4.4. Coherence

In evaluating how the AIFMD fits within a broader over-arching architecture, the degree of consistency between the provisions of the Directive was analysed (internal coherence). How

[255] Cf. EFAMA Response to the IOSCO Consultation on CIS Liquidity Risk Management Recommendations (CR04/2017), EFAMA, 2017.
[256] See https://www.iosco.org/news/pdf/IOSCONEWS405.pdf

it relates to other EU (legislative and non-legislative) and national actions (external coherence) was also assessed.

4.4.1. *Specific objective: All AIFM are subject to appropriate authorisation and registration requirements*

Sub-threshold AIFMs

With regard to *internal* coherence of the AIFMD provisions on authorisation and thresholds, it seems reasonable to assert that the requirements are coherent with other parts of the Directive. There is no evidence or commentary that suggests otherwise.

The coherence of Article 3(2) AIFMD is more appropriately assessed against other EU legislation (i.e. *external* coherence), because AIFMD promulgates an equivalent market entry barrier to other substantial EU legislative acts on regulated industries. Such *de minimis* regimes[257] are common within EU regulatory policies. The rationale of these policies may differ from case to case but most often relate to the principle of proportionality and subsidiarity, and the factual economic circumstance that most often the regulated industries are heterogeneous.

The most direct comparators of AIFMD are the requirements under UCITSD and MiFID II. UCITSD does not include exemptions or exclusions for small UCITS ManCos. Likewise, in MiFID II there is no authorisation exemption for small investment firms, but there is an exemption – at national discretion – for firms that provide only the service of receipt and transmission of orders. In the Member States that apply this exemption, firms are generally still subject to national authorisation requirements that mirror MiFID II.

Both UCITSD and MiFID II cover retail (as well as professional) clients or investors. It is therefore more relevant to consider legislation such as IORPD II.[258] Article 5 IORPD II provides that "…*Member States may choose not to apply this Directive, in whole or in part, to any IORP registered or authorised in their territories which operates pension schemes which together have less than 100 members in total. Subject to Article 2(2), such IORPs shall nevertheless be given the right to apply this Directive on a voluntary basis.*" The chosen indicator (number of members) and value (100) that differentiate between EU authorised and nationally regulated IORPs are different to those in AIFMD, but the principle is the same, and AIFMD and IORPD II can be regarded as coherent.

4.4.2. *Specific objective: Proper monitoring of macro-prudential risks*

Loan originating AIFs

Since there are no common rules for loan originating AIFs at present, it is not possible to evaluate coherence from a backward-looking perspective.

[257] Recital 17 AIFMD.
[258] Directive (EU) 2016/2341 of the European Parliament and of the Council of 14 December 2016 on the activities and supervision of institutions for occupational retirement provision (IORPs).

Supervisory reporting requirements

With regard to *internal* coherence, the reporting obligations for AIFMs partly do not give a consistent picture of the data. The data requested may vary in quantity and content depending on the Member State, because of the differing national legislation or rules that further articulate the reporting requirements under AIFMD. Also, the KPMG study results highlight that even within the AIFMD reporting template there is duplication.[259]

Reporting obligations to NCAs under AIFMD have also been assessed with regard to *external coherence*, i.e. their interplay with other relevant EU legislation. The respondents to the KPMG Survey mentioned the overlapping reporting obligations under other pieces of EU legislation as an issue that is deviating from a coherent approach. Indeed, the results of the Fitness Check of EU Supervisory Reporting Requirements[260] confirmed overlaps of the AIFMD with reporting under the Money Market Fund Regulation (MMFR) as well as with the ECB's collecting of the investment funds data for the statistical purposes. Some respondents called for harmonising the AIFMD reporting requirements with those under the EMIR, SII, CRR and other pieces of Union legislation, and at international level.[261]

Leverage calculation methodologies under AIFMR

Within AIFMD, the leverage, reporting, risk management and investor disclosure requirements appear to operate *inherently* coherent between the various components of the AIFMD.

The provisions are also *externally* coherent vis-à-vis other EU measures with similar objectives. The use of leverage in investment funds in the EU is comprehensively regulated for AIFs in AIFMD, and for UCITS in UCITSD and the CESR Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS, as well as in the ESMA Guidelines on ETFs and other UCITS issues.[262] These regulations and guidelines are generally coherent with each other, but the methodologies differ.

ESRB acknowledged in its report on shadow banking in Europe[263] the important progress made in improving the monitoring and risk assessment of "synthetic leverage" through the collection of data reported under AIFMD. These data can be aggregated with data collected under the coherent obligations in EMIR and SFTR, in order to provide NCAs, ESMA and ESRB a sufficient and thorough overview of the overall leverage and leverage risks in the European financial markets.

However, an AMIC/EFAMA report on leverage[264] remarks that in respect to the determination of leverage, the treatment of cash assets in UCITS and AIFs could be harmonised. Moreover, AMIC/EFAMA noted that in order to ensure consistency between

[259] (see 4.1.2 and 4.2.1 in Section 1). KPMG Report.
[260] Commission Staff Working Document Fitness Check of EU Supervisory Reporting Requirements, SWD(2019) 402 final, 6.11.2019.
[261] KPMG Report, p. 86.
[262] CESR Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS CESR/10-788 28 July 2010 (hereafter referred to as the CESR Guidelines); ESMA Final Report, Peer review on the Guidelines on ETFs and other UCITS issues 30 July 2018.
[263] ESRB, EU Shadow Banking Monitor No 2 / May 2017, pages 33-35.
[264] AMIC/EFAMA, Managing fund liquidity risk in Europe –an AMIC/EFAMA report, April 2016.

UCITSD and AIFMD it would be helpful to harmonise the calculation method of the gross leverage for UCITS using VaR approaches based on the gross method that applies for AIFs under AIFMD. In the light of IOSCO's work on common leverage measures, KPMG survey respondents and interviewees urged that the outcome of this work be considered and any changes to EU requirements be introduced simultaneously for UCITS and AIFs (see Section X).

4.4.3. Specific objective: Proper monitoring and limitation of microprudential risks

Delegation rules

With regard to the *internal coherence* of AIFMD, in addition to the main articles on delegation, there are specific rules on delegation of the valuation function. The KPMG survey and interview results relating to the main delegation rules and the further desk research did not raise any issues or questions as to their internal coherence with the delegation provisions for the valuation function. Neither did they raise any questions as regards to internal coherence of these rules with the broader set of rules on governance and risk management, or with the delegation rules for depositaries.

With regard to *external coherence* of the Directive, AIFMD sits alongside a multitude of other relevant EU/EEA legislative acts. On the basis of available quantitative and qualitative data, the coherence of AIFMD and similar provisions in other EU legislative acts is a mixed picture. It has been possible to detect both similarities and differences.

As far as the delegation of portfolio management and risk management is concerned, Article 20(1)(c) AIFMD requires the delegate to be an authorised or registered undertaking, able to provide the business of asset management, and subject to supervision or, where that condition cannot be met, prior approval by the relevant NCA of the home Member State of the AIFM. According to the ESMA AIFMR Advice, UCITS ManCos and MiFID investment firms are eligible counterparties in AIFMD delegation structures as these are considered to be authorised to provide asset management services and subject to supervision. The same standards apply under Article 13(1)(c) UCITSD.

There are however some differences between the comparable AIFMD and UCITSD provisions, but there is a reasonable degree of coherence of AIFMD with MiFID II and UCITSD. This is evidenced by ESMA often referring to MiFID II and UCITSD provisions when publishing clarifications on the application of the AIFMD delegation rules.[265]

Indeed, the KPMG survey and interview results did not indicate that any incoherencies with other legislation materially impact compliance with or the benefits of the AIFMD delegation rules. Often times, groups with both an AIFM and a UCITS ManCo (or one entity that is both) apply the same delegation controls across both their AIFs and their UCITS.

[265] Auslagerung von Anlageverwaltungsfunktionen, Dr. Ulf Klebeck, 2012, p. 230.

Risk and liquidity management rules

The AIFMD risk and liquidity management requirements are *internally* coherent with a number of other AIFMD provisions, including valuation, delegation and leverage. So far, no evidence came to light that suggests a lack of coherence between the risk and liquidity management requirements and other AIFMD provisions. In fact, as noted under *effectiveness* above, the large majority of respondents agreed that AIFMs must establish appropriate risk *and* liquidity management processes.

As regards *external* coherence, the picture is more mixed. While in the most corresponding legislative acts (UCITSD and MiFID II), risk management is an operating condition, i.e. a requirement that must be met in order to secure authorisation, AIFMD renders risk management to be an authorisation criterion, i.e. a regulated activity. An AIFM is defined as providing at least portfolio management and risk management. However, in practice, the industry does not seem to regard this legislative difference as a determinant of business models.

The AIFMD risk and liquidity management provisions are largely based on UCITSD, thereby ensuring coherence with e.g. Article 51(1) UCITSD.[266] Articles 15 and 16 AIFMD enhanced the governance structures envisioned under UCITSD require robust controls that ensure delivery of the risk profile disclosed to investors. Consequently, the regulatory requirements for AIFs and UCITS were aligned. Furthermore, the provisions of Articles 15 and 16 AIFMD align with the risk mitigation requirements for OTC derivative contracts under EMIR.[267]

Thus, the AIFMD risk and liquidity management rules can be deemed generally externally coherent with corresponding provisions in related EU legislation.

4.4.4. Specific objective: Common approach to protect professional investors in AIFM managed funds

Depository regime

With regard to *internal* coherence of the AIFMD provisions on depositaries, it seems reasonable to assert that the requirements are coherent with other parts of the AIFMD. We have identified no evidence or commentary that suggests otherwise.

As regards *external* coherence, the AIFMD depositary provisions were introduced for the first time and in a tightened form compared to the previous provisions under UCITS.[268] The UCITS depositary requirements have since been brought into line with those in AIFMD. Therefore, there is now a high level of coherence between AIFMD and UCITSD.

4.4.5. Specific objective: Develop the single market in AIF

[266] Cf. Geurts/Schubert, in Frankfurter Kommentar, KAGB (Frankfurt Legal Commentary for the German transformation Act of AIFMD), § 29, margin no. 6.
[267] EU Regulation 648/2012 of 4 July 2012 on OTC derivatives, central counterparties and trade repositories.
[268] Cf Article 22 et sec. UCITSD as well as De Blasi in Frankfurter Kommentar, KAGB (Frankfurt Legal Commentary for the German transformation Act of AIFMD), § 80 margin no. 1.

Single Market for EU AIFs

4.5. EU added value

EU added value refers to the changes and results observed in the area of alternative investment fund managers across the EU which could not have been achieved through action at regional or national levels.

The assessment of EU added value has relied mainly on desk research, specifically on comparisons with the situation in the EU before the Regulations took effect.

The AIFMD was the first legislative act concerning alternative investment fund managers in the EU. It represented the start of the development of a coordinated EU strategy to establish a harmonized and stringent regulatory and supervisory framework for the activities within the Union of all AIFMs.

The question of whether the AIFMD has generated EU added value is linked with the question of whether the results achieved surpass those which could realistically have been expected at Member States' level (i.e. through national interventions alone).

4.5.1. Specific objective: All AIFM are subject to appropriate authorisation and registration requirements

Sub-threshold AIFMs

The sub-threshold AIFM regime provides for NCAs to allow a lowered market entry barrier into domestic markets for smaller AIFMs. Besides the proportional application of operating conditions, the initial lighter registration regime makes AIFMD a more proportionate EU legislative act for market participants in the EU. This can be regarded favourably against the respective objectives of AIFMD.

However, given that a number of NCAs do not provide for the registration option or apply additional requirements (in some cases, the full AIFMD requirements) to registered AIFs, the causality relationship between the AIFMD sub-threshold regime and what has happened in practice cannot easily be assessed. Indeed, in some Member States it is likely that the impact of the national provisions is the over-riding driver of the current position in those markets.

4.5.2. Specific objective: Proper monitoring of macro-prudential risks

Loan originating AIFs

Since there are no common rules for loan originating AIFs at present, it is not possible to evaluate the EU added value from a backward-looking perspective.

Supervisory reporting requirements

Prior to the introduction of AIFMD, there was no consistent picture of reporting requirements for AIFMs. The reporting obligations were implemented by the NCAs with respect to national law, so there were differences between the NCAs in the data requested. Furthermore, the pre-AIFMD status lacked standardisation, and therefore comparability, between the different Member States' data sets.

Post-AIFMD, the same reporting requirements apply to all AIFMs and AIFs. The reporting regime has directly caused a significant improvement in increased transparency at the EU level. The collection of information through the AIFM reports to NCAs makes it easier for regulators to detect and respond to risks in the relevant markets on a harmonised level in the EU. This strengthens the monitoring of cross-border activities of AIFMs and enables the NCAs to identify systemic risks to the financial system, thereby contributing to financial market stability.

However, ESMA needs to have received data from all Member States and for a number of years, before market trends can sensibly be examined. Meanwhile, the industry and investors would welcome more publically available national analyses.

Leverage calculation methodologies under AIFMR

The AIFMD leverage provisions provide a consistent and standardised regulation in respect to the calculation, reporting and risk-mitigation of leverage within the EU. As a consequence, AIFMs are able to determine on the basis of standardised methods the relevant leverage ratio of an AIF, the relevant NCAs can receive data on a standardised basis in order to gain a sufficient overview about the overall leverage risk in their domestic financial markets, and ESMA can aggregate submissions from NCAs to form an overall view of the level of leverage in the European financial market as a whole.

Therefore, AIFMD has directly caused an improvement in the use and management of leverage in a consistent manner across the EU. Also, NCAs and ESMA are able to determine the reasonableness of the leverage limits set for each AIF by the relevant AIFM. Furthermore, they have the powers to introduce limits on leverage for a particular AIF or set of AIFs if they believe they potentially give rise to heightened systemic risks or pose a threat to financial stability.

4.5.3. Specific objective: Proper monitoring and limitation of microprudential risks

Delegation rules

Given that delegation by AIFMs of certain functions is a common activity in the EU, there is a significant amount of cross-border provision of delegated services. Therefore, a harmonised set of delegation provisions is a reasonable response from a regulatory point of view and is important for the benefits of EU market integration, which national measures alone could not achieve.

Also, it is clear from the KPMG survey evidence that the AIFMD delegation provisions have directly caused an increase in the number of delegation arrangements subject to scrutiny by the NCAs and in the duration and frequency of delegation reviews by AIFMs and their delegates. The fact that full liability remains with the AIFM, irrespective of the degree of delegation activities, together with the required functional and hierarchical separation of risk management from portfolio management, are positive examples of investor protection benefits and provide EU added value.

Risk and liquidity management rules

The AIFMD risk and liquidity management requirements were a robust response to the 2008 financial crisis.[269] They aimed to strengthen the European investment fund market by addressing liquidity management issues in an appropriate manner.[270] Furthermore, the provisions provide necessary safeguards for investors. They thereby promote investor confidence in investments in the broad universe of assets, including less liquid or illiquid investment, and facilitate increased access to capital markets and greater financing options for enterprises seeking to raise capital.

These two outcomes are also in accordance with the EU's aims under the CMU and would seem to imply that the AIFMD has resulted in positive outcomes for the EU (i.e. causality is indicated). However, the degree of influence is not clear given the results of the statistical research carried out by KPMG, which do not indicate that AIFMD has had a significant effect on growth in the EU AIF market (see Annex 4 to the KPMG report).

4.5.4. Specific objective: Common approach to protect professional investors in AIFM managed funds

Depository regime

Prior to the introduction of AIFMD, at EU level there were only regulations with regards to depositaries for UCITS, under UCITSD. Given this, and given the assessments above against the four other principles, it can be argued that the AIFMD depositary requirements have led to an improvement in the Single Market for AIFs.

Further, based on the evidence available, it can reasonably be asserted that the objective of the AIFMD depositary rules – to provide independent oversight of certain of the AIFMs' activities and to ensure safe-keeping of AIFs' assets – has been met and has directly led to improvement in the stability of AIF market and the safety of the investors' assets (i.e. causality is indicated).

The transitional provision that allows a depositary to be in a different domicile to the AIF has been of particular added value to smaller Member States, which might otherwise not have been able to develop domestic AIF markets.

5. CONCLUSIONS

Overall, it is concluded that the AIFMD is delivering on its objectives to bring the AIF market into a more coordinated supervisory framework based on a harmonised set of standards, promoting a high-level investor protection and facilitating greater integration of the AIF market. Market data shows that assets under the management of AIFs are growing, as are the cross-border activities of AIFMs.

[269] See the collapse and bankruptcy of the US investment bank Lehman Brothers on 15 September 2018.
[270] Cf. AMIC/EFAMA, Managing fund liquidity risk in Europe - an AMIC/EFAMA report, April 2016, p. 3.

Inadequate protection of fund investors
The AIFMD provides a high-level of investor protection. Rules on conflicts of interest, disclosure and transparency requirements all serve to protect investor interests, which is beneficial for building confidence in financial markets. This evaluation confirms that a dedicated regime regulating the functions and liability of depositaries proved to be an effective measure for enhancing investor protection.

Investor protection could be, however, improved by further clarifying AIFMD and AIFMR rules on delegation and clearly bringing in CSDs into the custody chain so that depositaries could exercise an effective oversight over the AIFs' activities. A common level of protection of investors into loan originating AIFs could be ensured by having Union rules on transparency for AIFMs managing such funds.

The possibility for EU AIFMs to market AIFs to retail investors is dependent on the permission of the individual Member States that may impose additional conditions as they deem fit.[271] The overall consequence of AIFMD has been less choice for retail investors, including for high net worth clients and semi-professional investors. The introduction of safeguards for investor protection is necessary at the Union level, but should be provided for in the context of the ELTIF review and in the PRIIPS Regulation instead of in the AIFMD.

Difficulties in monitoring and managing financial stability risks
The AIFMD requirements on supervisory reporting and on risk and liquidity management are valuable from a macro-prudential point of view and can help identify and mitigate financial stability risks. In 2019, ESMA published its first Annual Statistical Report on EU Alternative Investment Funds, which aggregates AIFs supervisory reporting data providing market participants and investors, as well as supervisors and policy makers, with information on market developments.[272]

However, a case is made for more streamlined reporting requirements, given identified overlaps with requirements under other Union laws, such as statistical reporting under the ECB regulations. IOSCO work, particularly on leverage, which focuses on the type of data to be provided to supervisors and provides further detailed input that concerns the AIFMR reporting template.

As regards leverage calculations, the evaluation concludes that the leverage calculation methods – the gross and commitment methods – currently provided in the AIFMR are satisfactory. The work of the FSB and IOSCO as well as recommendations of the ESRB concerning improved measures for assessing macro-prudential risks are also taken into account.[273]

Increasing non-bank lending raises concerns regarding financial stability as well as the level playing field among the financial intermediaries active in the credit market. On this basis,

[271] Article 43 of the AIFMD.
[272] ESMA Annual Statistical Report EU Alternative Investment Funds 2019, 21.01.2019, ESMA 50-165-748. (ESMA Statistical Report 2019) and ESMA Annual Statistical Report EU Alternative Investment Funds 2020, 10.01.2020, ESMA50-165-1032, (ESMA Statistical Report 2020).
[273] Recommendation of the European Systemic Risk Board of 7 December 2017 on liquidity and leverage risks in investment funds ESRB/2017/6, 2018/C 151/01.

some stakeholders call for consideration of Union standards for loan originating AIFs and supplementing the AIFMR reporting template with additional data fields relating to loan origination by AIFs. AIFMs managing loan-originating AIFs are not subject to any micro or macro prudential requirements that would be conducive to preserving stability of the financial system regardless of the noticeable growth of this market segment in Europe.

According to the ESRB recommendations liquidity management could be improved if open-ended AIFs located anywhere in the Union had a range of liquidity management tools to have recourse to during the stressed market conditions.

Inefficiencies in managing investment funds

The evaluation identifies a number of deficiencies that undermine the effectiveness of the AIFM passport. Gold-plating and the lack of a common understanding among NCAs of certain AIFMD rules or concepts as well as limited coverage of the AIFM passport produce inefficiencies. Sub-threshold AIFMs may have difficulties in satisfying all the requirements of the AIFMD and as a result refrain from cross-border activities while the authorised AIFMs are permitted to market their AIFs cross-border only to professional investors.

Similarly, the absence of an EU passport for depositaries leaves the market for depositary services fragmented and particularly impacts the supply side of these services in smaller markets. The affected Member States would welcome an introduction of the depository passport, whereas others prefer securities laws to be harmonised before introducing such a passport. Furthermore, there is a lack of clarity and regulatory gaps in relation to tri-party collateral management and custody services provided by central securities depositories.

Moreover, there are some calls to refine the allegedly binary nature of the valuation rules, whereby it is understood that a combined use of internal and external valuers is excluded, as well as uncertainty around the liability of external valuers due to a lack of the EU harmonisation of these issues.

The remuneration rules provided in the AIFMD are judged as having achieved the objective of bringing about a more risk-conscious approach to the management of AIFs. Nevertheless, following the changes to the CRD,[274] which include amendments to the rules on remuneration for staff of credit institutions, there is room for improvement regarding the measure of proportionality provided in the AIFMD.

Where financial instruments are involved, AIFMs are required to comply with the enumerated provisions of the MiFID.[275] To ensure a level playing field between investment firms and AIFMs where they provide competing services, the AIFMD should be aligned to cover the relevant obligations as laid down in the MiFID II.

Another level playing field issue relates to the national private placement regimes (NPPRs), which permit access of third country AIFMs and/or AIFs to the markets of individual Member States. NPPRs differ across Member States and, more importantly, implement only a very limited number of the AIFMD requirements thus creating an uneven playing field for

[274] Directive (EU) 2019/878 of the European Parliament and of the Council of 20 May 2019 amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures, OJ L 150, 7.6.2019, p. 253.
[275] Article 6(6) of the AIFMD refers to the obligations of Directive 2004/39/EC.

EU AIFMs. On the other hand, the NPPRs proved to play an important bridging role while the AIFMD passport for the third country entities has not been activated yet by means of a delegated act. As a result, investors in the permitting Member States have been able to access global markets for financial services allowing them to better diversify their investment allocation.

The evaluation confirms the key role that ESMA has been playing in promoting supervisory convergence among the NCAs as regards application of the AIFMD.

It transpires from the responses to the KPMG Survey and to the public consultation that stakeholders, initially resistant, seem to have recognised the added value of the AIFMD. Moreover, a number of issues that had been raised since the implementation of the AIFMD have been already solved by the recently adopted Union laws.

The Cross-Border Fund Distribution of Investment Funds package was adopted inter alia to increase transparency in relation to regulatory fees charged by NCAs for processing AIF notifications and in relation to national marketing rules.[276] The AIFMR has been recently amended to clarify asset segregation requirements where custody of assets is delegated to a third party.[277] The recent amendments to the CRD provide that AIFMs belonging to the same corporate group or conglomerate will have to apply the AIFMD rules on remuneration thus avoiding their being subject to concurrent set of rules regulating distinct financial intermediaries.[278] The EU regulation on sustainability related disclosures in the financial services sector is set to ensure coherence across different EU regulatory frameworks.[279] The recently changed European Venture Capital Fund Regulation opened up the use of the designations 'EuVECA' to managers of collective investment undertakings authorised under the AIFMD and expanded investment parameters.[280]

Other issues raised in this evaluation, however, may possibly warrant further action at the Union level to support the further development of the EU AIFs market and to respond to new technological developments ensuring that the AIFMD framework is fit for purpose.

[276] Directive (EU) 2019/1160 of the European Parliament and of the Council of 20 June 2019 amending Directives 2009/65/EC and 2011/61/EU with regard to cross-border distribution of collective investment undertakings, OJ L 188, 12.7.2019, pp. 106–115 and Regulation (EU) 2019/1156 of the European Parliament and of the Council of 20 June 2019 on facilitating cross-border distribution of collective investment undertakings and amending Regulations (EU) No 345/2013, (EU) No 346/2013 and (EU) No 1286/2014, OJ L 188, 12.7.2019, pp. 55-66.

[277] Commission Delegated Regulation 2018/1618 of 12 July 2018 amending Delegated Regulation (EU) No 231/2013 as regards safe-keeping duties of depositaries, OJ L 271, 30.10.2018, p. 1.

[278] Directive (EU) 2019/878 of the European Parliament and of the Council of 20 May 2019 amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures, OJ L 150, 7.6.2019, p. 253.

[279] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability- related disclosures in the financial services sector, OJ L 317, 9.12.2019, pp. 1–16.

[280] Regulation (EU) 2017/1991 of the European Parliament and of the Council of 25 October 2017 amending Regulation (EU) No 345/2013 on European venture capital funds and Regulation (EU) No 346/2013 on European social entrepreneurship funds.