

Asset Management & Investment Funds Update

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March 2023



AIFMD Review Series: Delegation and Substance

The AIFMD Review is set to enter inter-institutional negotiations, the so-called trilogue stage of the EU legislative process, following completion of the co-legislators' review of the Commission's AIFMD proposals (published end-2021) and publication of proposed amendments by the Parliament on 2 February 2023 and by the Council last June.

Current expectations are for trilogues to commence in Q2 this year and for a final text to enter into force by year end, which would mean an application date of Q4 2025 (assuming retention of the proposed two-year transposition period and immediate application).

The key topics under review remain largely unchanged following publication of trilogue texts - delegation and substance, loan origination funds, liquidity risk management, data and reporting, ancillary services, depositaries, related UCITS regime amendments - but there are some additions from the Parliament. Parliament has tabled proposals for third party managers (enhanced scrutiny of conflicts of interest), an independent director (for AIFMs managing retail AIFs), and undue costs (reporting by ESMA to EU legislators).

In this, the first in a new series of briefings from William Fry's Asset Management and Investment Funds team on the AIFMD Review proposals, we look at the key topic of delegation and substance and the institutions' positions on each proposal now subject to trilogue negotiations.

Overview of Proposals on Delegation and Substance

There is broad agreement across the institutions' proposals on this topic and in the main they focus on increased levels of reporting on delegation arrangements by AIFMs to NCAs, as well as by ESMA to EU legislators. This leaves the door open to further levels of regulation in this space but falls short of ESMA's August 2020 recommendations for quantitative letter-box rule amendments and calls for an urgent response to third-country delegation concerns. Nonetheless, the enhancement of an already detailed and prescriptive supervisory reporting regime is undoubtedly challenging, not to mention potentially costly. In addition, the provision in the proposals for the adoption of various delegated measures could delay certainty of the substantive impact of these proposals until after they enter into force.

Proposals In Detail

1. *Enhanced AIFM application for authorisation to include additional details of delegation arrangements*

Commission proposal: extend the level of information required as part of the AIFM authorisation application to include additional detail on the AIFM's resources to carry out its functions and those in place to monitor and oversee delegates.

Council and Parliament views: both support the proposal, with the Parliament proposing enhancements including additional information on full or partial delegation status, delegate details, an explanation of the added value of the delegation for investors and post-authorisation reporting of any material changes. The Parliament also proposes the adoption of delegated measures to standardise and templatised the enhanced authorisation application and to specify situations where the name of proposed underlying AIFs may be 'materially deceptive or misleading to the investor' (possibly with the intention to legislate for the upcoming ESMA fund name guidelines).

2. *At least two full-time EU resident employees/FTEs*

Commission proposal: require AIFMs to employ at least two full-time persons or otherwise engage two persons on a full-time basis who are resident in the EU.

Council and Parliament views: both support the proposal, with Parliament additionally allowing for full-time equivalent commitments and Council allowing for full-time board members to meet the requirement.

3. *Application of delegation rules to all Annex I functions and any IPM or non-core services*

Commission proposal: clarify that AIFMD delegation rules are applicable to the delegation of investment management functions, other functions (administration, marketing, AIF asset related activities), individual portfolio management, or non-core services (investment advice, safekeeping and administration, receipt and transmission of orders).

Council and Parliament views: both support the proposal with the Parliament proposing enhancements to clarify that the AIFM is responsible for ensuring that underlying AIFs are managed in accordance with AIFMD rules irrespective of the regulatory status or location of any delegate or sub-delegate.

4. *Distributors not delegates if not acting under the control of the AIFM*

Council and Parliament proposal: clarify that distributors acting on their own behalf and marketing an AIF under MiFID or through insurance-based investment products are not delegates of the AIFM and the AIFMD delegation rules will not apply irrespective of any distribution agreement between the AIFM and the distributor.

Commission view: the proposal does not appear in the Commission's review; however, it would appear to be somewhat at odds with the Commission's July 2022 Q&A on distribution. In the Q&A, the Commission clarifies the application of AIFMD delegation rules to the marketing function and 'the principle of full responsibility of fund managers' for delegation of that function. The Commission also states that fund managers are responsible for compliance with the Cross-Border Distribution of Funds regime, irrespective of who is actually distributing the fund and whether the fund manager has a contractual or other relationship with that distributor.

5. *Enhanced supervisory reporting including on delegation and sub-delegation arrangements*

Commission proposal: ESMA to develop draft regulatory technical standards to replace the current Annex IV reporting template.

Council and Parliament views: both support the proposal but also specify enhancements now to include reporting on delegation and sub-delegation arrangements for portfolio or risk management including resources of the AIFM for performing retained functions, of the delegate for performing delegated functions and of the AIFM for monitoring and controlling the delegate as well as ongoing delegate due diligence measures of the AIFM.

6. *NCA reporting on AIFM delegation arrangements to ESMA*

Commission proposal: NCAs to report annually on AIFM delegation practices to ESMA including on AIFM arrangements where more risk or portfolio management is delegated to third countries than is retained. ESMA to report regularly to EU legislators on market practices regarding delegation to third country entities.

Council and Parliament views: neither support the proposal for annual NCA reporting to ESMA. Both support the proposal for ESMA to report to EU legislators on market practices for delegation although not on a regular basis but instead either ahead of the next scheduled AIFMD review (Council) or 24 months after this AIFMD review becomes applicable (Parliament).

7. Third party AIFMs

Parliament proposal: AIFMs which manage AIFs where a third party has significant control over the AIF's design, distribution and management, must 'employ heightened scrutiny of the potential for conflicts of interest' and evidence this to the home NCA. ESMA is charged with drafting technical standards for the types of conflicts that may arise and the criteria for use by NCAs to assess AIFMs' compliance with these provisions.

Council and Commission views: N/A

Next steps

Further details to follow as the proposals progress through the EU legislative process.

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