

ASSET MANAGEMENT AND INVESTMENT FUNDS

ESMA Recommends Legislative Review of Delegation under the AIFMD and UCITS Frameworks

3 September 2020

The European Commission (“Commission”) is currently reviewing the Alternative Investment Fund Managers Directive (EU/2011/61) (“AIFMD”).

Ireland Law Firm of the Year 2020
Chambers Europe Awards

Ireland Law Firm of the Year 2020 & 2018
International Financial Law Review (IFLR)
Europe Awards

Structured Finance & Securitisation Deal of the Year 2020 – Stenn trade receivables securitisation
IFLR Europe Awards

Ireland M&A Legal Adviser of the Year 2019 & 2018
Mergermarket European M&A Awards

Best Firm in Ireland 2019 & 2018
Europe Women in Business Law Awards

Best National Firm for Women in Business Law 2019 & 2018
Europe Women in Business Law Awards

Best National Firm Mentoring Programme 2019 & 2018
Europe Women in Business Law Awards

Best National Firm for Minority Women Lawyers 2019 & 2018
Europe Women in Business Law Awards

Ireland Law Firm of the Year 2019 & 2018
Who's Who Legal

Most Inclusive Law Firm 2019
Managing Partners' Forum Awards

Ireland Client Service Law Firm of the Year 2018
Chambers Europe Awards

Equity Deal of the Year 2018 – Allied Irish Banks IPO
IFLR Europe Awards

The purpose of the Commission's review is to examine the scope and application of AIFMD to establish its impact on investors, AIFs and both EU and non-EU AIFMs, and to determine the extent to which AIFMD's objectives have been achieved.

The Commission began its review in 2018 with a general survey about the functioning of AIFMD. The [results](#) of that survey were published in January 2019. The Commission noted that most of the AIFMD provisions were assessed as having achieved their objectives, but also identified areas requiring further analysis. Building on the results of that initial survey, the Commission continued with its review of AIFMD and on 10 June 2020 published its [report](#), which included key findings with regard to the impacts on AIFs and AIFMs, investors, and on monitoring and assessing systemic risk. (Please see our previous article [here](#), for more information on the report).

The Commission is also mandated to propose legislative amendments to AIFMD on foot of its review. In this context, ESMA has written to the Commission with a number of recommended changes to AIFMD. Notably, a number of the recommendations proposed by ESMA also include corresponding amendments to the UCITS framework and so the proposals are of relevance not only to AIFMs, but also to UCITS and UCITS management companies.

ESMA's [letter](#) is extensive and includes

recommendations for both policy and reporting enhancements to the AIFMD legislative framework. Changes are proposed across nineteen areas, including:

- harmonising the AIFMD and UCITS regimes;
- delegation and substance;
- liquidity management tools;
- leverage;
- the AIFMD reporting regime; and
- the harmonisation of supervision of cross-border entities.

This briefing focuses on the recommendations around delegation and substance, which will be of keen interest to all authorised AIFMs and UCITS management companies (including self-managed UCITS).

Extent of delegation

ESMA notes the large extent to which AIFMs and UCITS management companies delegate portfolio management functions to third parties. These third parties may be part of the management company's group or not and may also be non-EU entities. While acknowledging that delegation can increase efficiencies and ensure access to external expertise, ESMA has concerns that these delegation arrangements may also lead to increased operational and supervisory risks. In particular, ESMA notes that delegation to non-EU entities may call into question

ESMA Recommends Legislative Review of Delegation under the AIFMD and UCITS Frameworks.

whether the AIFs and UCITS can still be effectively managed by the authorised AIFM or UCITS management company. In this context, ESMA believes that further legal clarifications on the maximum extent of delegation would be helpful to ensure supervisory convergence and ensure that authorised AIFMs and UCITS management companies maintain sufficient substance in the EU. ESMA suggests that the Commission review the provisions around deeming an AIFM a “letter-box entity” in the AIFMD Level 2 Regulation and reconsider and/or complement the qualitative criteria set out therein with clear quantitative criteria, or provide a list of core functions that cannot be delegated and must always be performed internally within the AIFM. As there are no corresponding provisions in the UCITS Directive, ESMA has recommended that these considerations should also be included in the UCITS framework.

ESMA believes that as a result of Brexit (and the UK becoming a non-EU country) an increase in delegation to non-EU entities is likely. As such, ESMA has suggested that any legislative amendments on foot of its recommendations could be provided in line with the delegation/substance guidance in its Opinion on Supervisory Convergence in the context of Brexit (“Opinion”). That [Opinion](#) sets out principles based on the objectives and provisions of AIFMD and the UCITS Directive and addresses regulatory and supervisory arbitrage risks related to any relocation of activities and functions of UCITS management companies (including self-managed UCITS) and authorised AIFMs to the EU-27 as a result of Brexit. The Opinion also provides further clarity on the interpretation of the delegation requirements and the common supervisory focus in this respect. In particular, it provides guidance on how national regulators should assess delegation arrangements noting that national regulators “*should give special consideration to the appointment of investment advisers in order to ensure that the delegation rules prescribed in EU investment management legislation are not circumvented*”.

The Opinion notes that authorised AIFMs and UCITS management companies should not delegate investment management functions to the extent that the delegated functions far exceed those performed internally and that national regulators should apply enhanced scrutiny to entities relocating in response to Brexit that, irrespective of the nature, scale and complexity of their operations and investment strategies, “*do not dedicate at least 3 locally-based FTE ... to the performance of portfolio management and/or risk management and/or monitoring of delegates*”.

Applicable regime in case of delegation

ESMA states that there may be divergences in Member States’ application of the various regulatory regimes that EU delegates may be subject to (MiFID, AIFMD, UCITS) and that delegation to non-EU entities means that the third-country delegate is not subject to the EU legislative framework and that this raises questions of effective supervision and investor protection. Therefore, to avoid regulatory arbitrage and protect EU investors, ESMA recommends legislative amendments to ensure that the management of AIFs and UCITS is subject to the regulatory standards set out in the AIFMD and UCITS frameworks, irrespective of the regulatory license or location of the delegate. It is not clear from the letter what amendments ESMA proposes in this regard.

Secondments

ESMA has seen an increasing use of secondment arrangements where staff from other group entities or from professional services firms/consultancies are seconded to the AIFM or UCITS management company on a temporary basis. In some of those cases, ESMA notes that the seconded staff are operating in a different Member State to the Home Member State of the authorised AIFM or UCITS management company, and in some cases the staff are outside of the EU. ESMA cites the example of staff of seven other group entities being seconded to an EU authorised entity but continuing to work from their usual offices outside of the EU on a secondment rather than delegation basis. ESMA is suggesting that legislative clarifications could address the issue of whether these types of secondment arrangements are in line with the substance and delegation rules set out in the AIFMD and UCITS frameworks.

Collective portfolio management functions and supporting tasks

One of the main conditions for the delegation of investment management functions under both AIFMD and the UCITS Directive is that generally the delegate is regulated in its home jurisdiction. In addition, delegation must not prevent the effective supervision of the AIFM or UCITS management company and, in the case of AIFMs, there must be an objective reason for the delegation. The ESMA letter notes that group entities frequently provide “supporting tasks” to the AIFM or UCITS management company. However, there is a lack of clarity as to what activities constitute a supporting task and accordingly there are divergent views between national regulators as to whether the tasks are in fact supporting tasks, or whether they are collective portfolio management activities that

should be subject to the delegation rules under AIFMD and the UCITS Directive. Therefore, ESMA is suggesting more granular requirements in this respect to ensure legal certainty and supervisory convergence.

White-label providers

ESMA has called for more specific requirements on white-label providers (i.e. AIFMs or UCITS management companies whose business model is to provide services primarily to third party delegate investment managers that are not themselves AIFMs/UCITS management companies). ESMA indicated that some national regulators have expressed doubts as to whether these business models are in line with the AIFMD and UCITS regimes.

Next Steps

The Commission is expected to issue a consultation on its proposed changes to AIFMD in Q4 2020. If ESMA’s recommendations are taken on board by the Commission, then they are likely to be included in the Commission’s consultation. This will provide an opportunity for AIFMs and UCITS management companies to comment on these and other proposals. Any subsequent legislative proposals are likely to follow in mid-2021. The legislative proposals will then be subject to the EU’s legislative process. Corresponding amendments to the UCITS framework can be expected if ESMA’s recommendations are incorporated into the AIFMD framework.

Comment

The Central Bank’s review of its Fund Management Company Guidance (or “CP86”), which it commenced in June 2019, focused, amongst other things, on organisational effectiveness and the fund risk management and investment management functions. The results of this review are expected in H2 2020 and these results will inform the Central Bank’s regulatory and policy position going forward. As such, further guidance on the Central Bank’s expectations on substance and delegation are likely to be included in the Central Bank’s findings. Therefore, AIFMs and UCITS management companies should continue to monitor closely developments at both EU and domestic Irish level.

We will continue to update you on these topics and are available to advise you on any proposed business, governance and delegation models in light of existing and anticipated regulatory requirements.

We will also be issuing a separate briefing on the other elements of the ESMA letter.

KEY CONTACTS

If you would like to discuss the foregoing in more detail, please do not hesitate to contact a member of our team.



Kevin Murphy
Partner
+353 1 920 1177
kevin.murphy@arthurcox.com



Tara O'Reilly
Partner
+353 1 920 1787
tara.oreilly@arthurcox.com



Sarah Cunniff
Partner
+353 1 920 1171
sarah.cunniff@arthurcox.com



Dara Harrington
Partner
+353 1 920 1206
dara.harrington@arthurcox.com



Cormac Commins
Partner
+353 1 920 1786
cormac.commins@arthurcox.com



Ian Dillon
Partner
+353 1 920 1788
ian.dillon@arthurcox.com



Siobhán McBean
Partner
+353 1 920 1052
siobhan.mcbean@arthurcox.com